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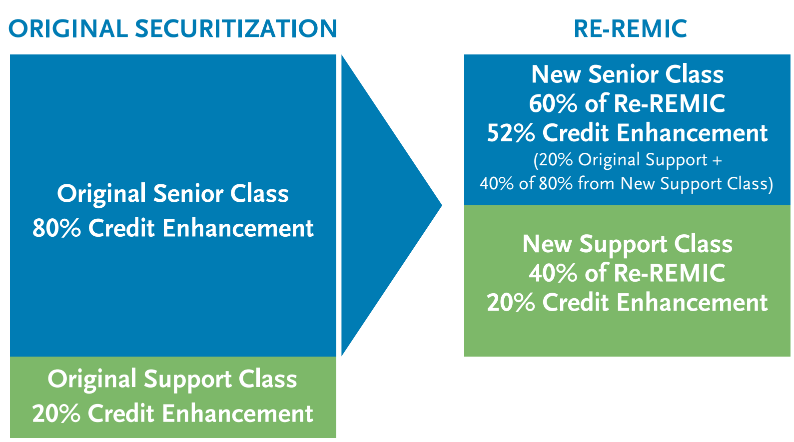
INSIGHT

The TCW Advantage: Scoring Points While Playing Defense in Non-Agency RMBS

MICHAEL HSU | FEBRUARY 18, 2016

The sports cliché that defense wins championships was proven true when the Denver Broncos defeated the Carolina Panthers to claim victory in Super Bowl 50. Starting a 39-year old quarterback who managed only 141 yards of passing, the Broncos relied on their stingy defense to lead the way, which recorded four forced fumbles (one of which directly lead to a touchdown), one interception, and seven sacks. In a similar way, the same can be said about investing. A strong defense can also lead to strong returns as it allows the investor to play offense from a position of strength while avoiding drawdowns. In more rare instances, it also has the ability to score points directly, just like the Broncos defense did five times throughout the regular season and once in the Super Bowl. By actively participating in the creation of Re-REMIC seniors, we have solidified our defense against market volatility by shortening spread duration and adding credit protection. Moreover, we have recently found ourselves in a unique situation where our Re-REMIC transactions are creating scoring opportunities as well.

In February 2015, we first covered the topic of Re-REMICs in our Monthly Mortgage Monitor where we highlighted the workings and value of these structures. As a brief recap, a Re-REMIC is a restructuring of an existing REMIC security into additional cusips with different cash flow priorities. The original bond is divvied up into two or more pieces with a senior and subordinate structure (see below for an example structure). The senior tranche receives all of the principal payments on the underlying bond until it is paid off while the subordinate tranche acts as credit enhancement for the senior by taking any losses allocated to the underlying.



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Similar to the original REMIC, the new Re-REMIC structure aims to appeal to a broader set of investors. With the universe of non-agency RMBS outstanding continuing to shrink by approximately one percent every month (through a combination of prepayment, amortization, and default), investors hungry for more opportunities are looking beyond traditional securitizations and to Re-REMICs to satisfy their individual risk appetites and return targets. Dividing the priority of payments from a singular source of cash flow opens participation to a larger set of investors. Money managers and insurance companies are drawn to the seniors, which offer relatively defined payment windows and stable yield profiles with greater protection from principal writedowns through the subordination of one or more tranches. Additionally, most seniors are discount dollar priced assets that receive paydowns every month, pulling price to par and providing carry in addition to interest income. Subordinates stand on the other risk/return spectrum and appeal to the hedge fund community by swapping stability for higher potential returns. These structurally levered, locked out cash flows would disproportionally benefit from a continued housing recovery as well as any rep and warranty legal settlements awarded to the underlying (such as those already approved for Countrywide and Citigroup), but in return would be subjected to significantly higher mark to market volatility and credit risk.

While we addressed the output/demand side of the Re-REMIC formula, what about the input/supply – where does the underlying collateral come from? Similar to buyers motivated by their specific preferences, sellers of the underlying collateral are also looking to refine their non-agency RMBS exposure through Re-REMICS. They either reduce their exposure by selling the underlying bond altogether or retain some portion of the structure to gain the benefits as described in the previous paragraph. In the case of the former, a bond holder could create a Re-REMIC and sell both the senior and subordinate with a weighted average theoretical price higher than what the underlying security would trade outright. That's because demand for the tranches separately is strong enough to drive prices to levels that generate an arbitrage opportunity. In fact, it is the aggressive demand for the subordinate piece that makes the economics of Re-REMIC creation truly possible. Hedge funds, in particular, were big buyers because it allowed them to reach elevated return targets in a low interest rate and flat credit curve environment. In the below table, we break down the economics of a sample trade as it would look at the beginning of 2015. Here we assume the underlying bond has 100mm current face, which is split into a 60mm senior tranche and a 40mm subordinate tranche. The 40% credit enhancement is provided just as an illustration; actual levels of enhancement will vary from each transaction depending on the underlying collateral and specifications of a rating agency if the senior is rated.

ORIGINAL SECURITIZATION

Tranche	Weight	Price	Cost ($100mm par)
Underlying	100%	$89	$89mm
Senior	60%	$98	$58.8mm
Subordinate	40%	$78	$31.2mm
Theoretical Underlying Price		$90	

- Example assumes underlying bond has 100mm current face, which is used to create a Re-REMIC with 60mm senior and 40mm subordinate
- The difference between the theoretical underlying price and the actual price reflects significant demand for the subordinate tranche from investors such as hedge funds

With the subordinate portion of Re-REMICs garnering plenty of attention and support, we were more than happy to take advantage of the supply it created in the senior portion and were very active in adding and creating these assets while rolling up in quality. During 2015, Re-REMIC issuance totaled 22bn across the capital structure of seniors and subordinates, most of which occurred during the first half of the year. Of that 22bn, TCW was involved in approximately seven percent (including only new issues during 2015 and excluding Re-REMICs purchased in and out of comp), all concentrated in seniors and majority rated investment grade by either DBRS or Fitch. However, if we assume the average amount of subordination across all Re-REMICs is 40%, the total amount of super seniors created was 13bn (22bn x 60%), which puts our involvement in comparable tranches closer to 12%. We leveraged our systems and abilities in analyzing both the structure and underlying collateral to trade some upside potential for shorter cash flow streams, more stability, and more credit enhancement to the extent we extracted value for our investors.

The Re-REMIC machine kept churning out bonds up until the middle of 2015 when global macro volatility began to rise and weakness in risk assets was felt in all corners of the market. Even though the fundamentals of the underlying collateral in non-agency RMBS continued to improve, the environment and economics of creating Re-REMICs reversed course and issuance

	ORIGINAL TRANSACTIONS			CURRENT MARKET LEVELS		
Tranche	**Weight**	**Price**	**Cost ($100mm par)**	**New Price**	**Market Value**	**Profit/ (Loss)**
Underlying	100%	$89	$89mm	$88	$88mm	$(1mm)
Senior	60%	$98	$58.8mm	$99	$59.4mm	$0.6mm
Subordinate	40%	$78	$31.2mm	$68	$27.2mm	$(4mm)
Theoretical Underlying Price		$90		$86.6		$(2.6mm)

- This table shows both the underlying and subordinate are down in price at the end of 2015, while the senior is up slightly

volume dropped off dramatically. The credit curve steepened materially as demand for high quality, stable profiles remained robust whereas that for lower dollar price, higher spread duration bonds suffered. In Re-REMICs, this meant investors were still willing to add in the senior portion, but the critical support for the subordinate tranches disappeared and prices were framed significantly lower. From our sample trade above, the following table shows updated prices towards the end of 2015. While the senior Re-REMIC was likely flat to slightly higher, both the underlying and subordinate were weaker – the underlying by only 1 point but the subordinate by 10 points, if not more.

As broader markets continued to weaken, not only were buyers of subordinates absent, existing holders were turning into sellers. To get out of the trade, these holders were faced with two options – sell their position at levels likely in excess of 10 points down and realize a loss of at least 4mm, or attempt to collapse the Re-REMIC structure and potentially get better execution on the underlying bond. In order to collapse, they would first need to approach senior bondholders and purchase the entire tranche. And if successful, they would then need to sell the underlying cusip at a price higher than what was implied by the pricing of the senior and subordinate tranches separately so that their losses would be reduced to 2.6mm, as shown above. Losses could be further minimized if they were able to get their hands on the seniors as cheaply as possible, pushing the theoretical underlying price even lower. However, holders of senior tranches, such as ourselves, are not obligated or motivated to sell so that subordinate bondholders minimize their losses. Furthermore, we continue to like the short and stable profile of seniors and are reluctant to give up such attractive securities. Therefore, for us to let the subordinate holders "out of the trade" in which we hold the seniors, we would demand a premium from the $99 price shown above. Our objective is to execute trades at levels shown in the table below on the far right.

ORIGINAL TRANSACTIONS				CURRENT MARKET LEVELS			TCW DESIRED EXECUTION LEVELS		
Tranche	**Weight**	**Price**	**Cost ($100mm par)**	**New Price**	**Market Value**	**Profit/ (Loss)**	**TCW Price**	**Market Value**	**Profit/ (Loss)**
Underlying	100%	$89	$89mm	$88	$88mm	$(1mm)	$88	$88mm	$(1mm)
Senior	60%	$98	$58.8mm	$99	$59.4mm	$0.6mm	$103	$61.8mm	$3mm
Subordinate	40%	$78	$31.2mm	$68	$27.2mm	$(4mm)	$68	$27.2mm	$(4mm)
Theoretical Underlying Price		$90		$86.6		$(2.6mm)	$89		$(5mm)

- Our goal is to execute at levels shown in the far right, which increases our gain from 0.6mm to 3mm and subordinate holder's loss from 2.6mm to 5mm

Our defensive positions in seniors are now allowing us to play offense. Rather than accept a 0.6mm profit, we would instead hold out for a gain of 3mm, which represents a price markedly above fair market levels and a spread at or near zero, and in some cases negative. The owners of the subordinate, on the other hand, are not as fortunate. On top of enduring an additional loss from a higher theoretical underlying price, they must put up a large amount of cash to buy back the senior and then bear the risk of selling the underlying once the Re-REMIC structure is collapsed. Even still, the subordinate bondholders may find it attractive to pursue this route because liquidity for subordinates in general has become extremely poor. Even though the bond is potentially "marked" at $68, there is no guarantee a sale could be completed at that level, or any level because it's entirely possible that there is no bid at all for the subordinate tranche. As a result, a sale at any price allows the subordinate holder to exit the trade entirely and insulates them from further loss as broader markets continue to struggle. And it is this negative feedback dynamic of deteriorating market liquidity and prices on subordinates that further motivates their holders to exit at any cost, which then conversely pushes up their bid on the seniors.

In football or any other sport, a high powered offense is exciting for both the players as well as spectators. Over the past two years, hedge funds had been on the offensive as they added aggressively in the subordinates of Re-REMICS, which allowed them to score slightly higher returns for a period of time while taking on significantly more risk. Meanwhile, we remained focused on improving the quality of our positions and took what the market gave us, which were defensive positions in senior tranches that offered much better risk adjusted value and steady, if unspectacular, gains. Market conditions have now changed where our defense is allowing us to set the pace of the game and score excess returns. We took advantage of the opportunities in building positions in seniors and are now capitalizing on the unique opportunities in unwinding them, ultimately creating superior value for our clients in all scenarios. Just as in sports, the world of investing is showing that defense can win championships and to the extent that volatility remains elevated, we will continue to be in a position of strength ready to capitalize on the "turnovers" of the market.

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