

Finding Value Amid Wall of Worry in Bonds

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In 2022, mortgage-backed securities (MBS) posted the worst annual return since the inception of the Bloomberg U.S. Mortgage Backed Securities Index. This year, MBS has continued to struggle amid the continued rise in rates, noise from regional bank portfolios and the gentle drain of the Federal Reserve's support, in the form of quantitative tightening.

Our asset allocation team believes we are at an inflection point, where the negative narrative is sharply misaligned with fundamentals. We upgraded our outlook for MBS and increased allocations to the [WisdomTree Mortgage Plus Bond Fund \(MTGP\)](#) in several of our Model Portfolios. The move was triggered by a compelling valuation story and the desire to take some chips off the table after the strong recent performance of high-yield securities.

We had the pleasure of hosting Dave Goodson, Head of Securitized Credit at Voya and a portfolio manager for [MTGP](#), on our *Behind the Markets* podcast to discuss the asset class and the opportunities and risks he sees within it.

One line from the podcast summarizes the opportunity well: *"Buyers are nowhere to be found when this market is at its cheapest."*

Our asset allocation team is one of the buyers. Here's why:

Homeowners' Equity Will Keep Defaults Low

The mortgage market has a lot of unique elements, but one reason the Voya team likes residential mortgage bonds is because of home buyers who purchased two to three years ago and have seen their properties increase in value. Ninety percent of homeowners have mortgages at rates below 4%, so they built equity and will protect that by paying off their debt.

Agency Mortgage Spreads at 99th Percentile Observations over Last Five Years

The raw yield pick-up in some mortgage bonds is approaching 2% over 10-Year U.S. Treasuries, when the typical spread would be about half that. Option-adjusted spreads that account for potential for refinancing risk are about 80 basis points wide and they also are usually half as wide. These yield spreads are historically wide and offer extreme relative value, in Voya's view

- Agency MBS form the largest component of the securitized asset market, with \$9 trillion of outstanding bonds. This is also the most liquid universe of fixed income securities behind U.S. Treasuries.

What Is Supporting These Historic Spreads?

Lack of sponsorship within a difficult rate environment is propping up these spreads. Banks have historically served as a prominent marginal buyer. But with deposits flowing out of banks, they are having to sell mortgages or let them roll off their balance sheets. Additionally, the Fed is scaling back the amount of its mortgage-backed holdings as part of its quantitative tightening program, diminishing support from another traditional valuation insensitive buyer. With banks and the Fed stepping away from the market, supply has to be absorbed by asset owners attracted to relative value.

Is Political Dysfunction Causing Bond Distress?

While Goodson did not attribute the agency fears to lack of support for the government-sponsored entities (GSEs) yet, he does think some of the rate volatility we've seen in the market is attributable to the prevailing political dynamics, illustrated by the downgrade of the U.S.'s credit rating.

Once you venture outside agency pass-through securities, better yields are prevalent across securitized credit sectors. Taking positions in structures with senior claims (or at the top of the credit structure) can secure you 7%–8% in loss-adjusted yields with very high—and AAA in some cases—credit ratings.

Positions with subordinate claims across securitized credits, and the assumption of a little more credit risk, can put investors into yields with low double digits and in most cases still carry investment-grade credit ratings.

Are Office Property Concerns Casting a Shadow over Commercial Mortgage-Backed Securities?

Office property has a different cycle than the housing market. But the market has not necessarily been efficient and understanding that it's not all bad news here. Usually, real estate is all about location, but right now property type is the differentiator. Offices, particularly in central locations, face a very different set of conditions than other parts of the commercial mortgage-backed market, such as multi-family, industrial, hotel and retail properties. Voya looks for opportunities in these sectors, whose valuations have been negatively impacted by spillover of fears from the office sector.

Are There Less Promising Prospects for Collateralized Loan Obligations?

One area of risk in the market where yields are high but not high enough to compensate for the risks is the collateralized loan obligations (CLO) sector, where Goodson is more skeptical. His team is worried about a credit cycle impacting these small businesses that have floating rate loans. Voya thinks there are more abundant opportunities to take risk with appropriate compensation, so they are defensively positioned within the CLO space.

Despite the current risks within the office sector of commercial real estate and CLOs, Goodson is enthusiastic about opportunities in the agency MBS and securitized credit spaces, and the ability of active managers to navigate these risks.

Listen to the full discussion below.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of an investment will fail to pay interest and principal in a timely manner, or that negative perceptions of the issuer's ability to make such payments will cause the price of that investment to decline. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on. Liquidity risk may result from the lack of an active market, reduced number and capacity of traditional market participants to make a market in fixed income securities, and may be magnified in a rising interest rate environment and/or with respect to particular types of securities, such as securitized credit securities. Non-agency and other securitized debt are subject to heightened risks as compared to agency-backed securities. High yield or "junk" bonds have lower credit ratings and involve a greater risk to principal. Derivative investments can be volatile and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Unlike typical exchange-traded funds, the Fund is actively managed using proprietary investment strategies and processes and there can be no guarantee that these strategies and processes will be successful or that the Fund will achieve its investment objective. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.