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The case for investing in the Non-agency RMBS market in a time of rising interest rates and strengthening economic conditions

Summary: We believe that the Non-Agency Residential Mortgage-Backed Securities (RMBS) market will be shielded in large part from the effects of rising interest rates by several mitigating factors that result from continued improvement in the US economy, including:

- Home price appreciation;
- Increased credit availability;
- Decreased unemployment coupled with employment mobility; and
- Increased consumer income.

Additionally, we believe that structural factors of the legacy Non-Agency RMBS market, discussed below, offer further upside in a strengthening economic environment. In our view, all of these factors should offset any effect that rising interest rates will have on the broader market, and allow for strong continued returns in the RMBS market.

Underlying collateral performance: a strong economy means strong upsides for American homeowners

The US economy has continued to improve, with a strengthening job market, increased consumer spending, and growing production. To the extent that these trends continue, more borrowers are expected to:

- Refinance their mortgages as home price appreciation results in positive equity on their home loans for the first time since the housing crisis.
- Pay off their loans as unemployment declines, employment mobility increases, and income rises, resulting in overall default rate decrease

RMBS securities are further shielded from traditional volatility that may arise as rates increase, as the above effects are slow in playing out among homeowners, as opposed to government or corporate credit. The timing of rate changes, and therefore subsequent mortgage rate increases, do not fully affect these securities immediately.

Structure of Non-Agency RMBS market allows for economy-based cash flow appreciation, not just market price changes

Non-Agency RMBS are often purchased at a discount (*e.g.*, 70s or 80s) due to the assumed default rate of borrowers. As the economy improves, lower-credit borrowers may be able to refinance their homes – or simply make their monthly payment, bringing these securities closer to par value. As opposed to traditional high-grade bonds, which are typically priced near or even above par value, we continue to believe that there is significant upside for non-agency RMBS in a strengthening economy.

We believe low duration, which decreases sensitivity to interest rates, makes Non-Agency RMBS attractive among other fixed income sectors

The majority of Non-Agency RMBS we hold are legacy securities, having been originated in the mid-2000s. Therefore, their cash flows on average have shortened compared to traditional bonds, which have continued to be reissued. Additionally, around 50% of the sector has variable coupons. As rates rise, these coupons reset higher, cash flows increase, and prices are protected as long as credit quality does not decline.

Semper Capital Management, L.P, founded in 1992, is a private, SEC registered, minority-owned and operated investment advisory boutique focused on mortgage-backed securities.

Semper Capital currently manages over $1.3 billion for a diverse base of institutional and wealth management clients and offers a wide array of MBS products, ranging from index-based passive and active strategies to absolute return hedge fund vehicles.

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Example: Alt-A and Subprime fixed rate paper

- Majority originated at 2-3%, so already out of the money as-is
- Prepayments largely due to relocations, not refinances
- Negative equity in homes post-crisis means that house price appreciation allows for sales, which means prepayments
- Relocations or refinances allow release from onerous legacy mortgage insurance

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Definition: Duration: Measure of a bond or bond portfolio's sensitivity to changes in interest rates. Generally, the longer the duration, the greater the price change relative to interest rate movements.