Semper MBS Total Return Fund Quarterly Conference Call

July 20, 2017, 11:30 a.m., E.T.

Chairperson: Greg Parsons, CEO, Semper Capital Management, L.P.

Definitions:

Cash Flow: Mortgages typically have required monthly interest and principal payments which are collected by servicers of mortgage-backed securities trusts, which in turn distribute these payments to MBS investors.

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.

Basis Points: A unit of measure that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument.

Barclays US MBS Index: Covers agency mortgage-backed pass-through securities - both fixed-rate and hybrid ARM - issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). Pool aggregates must have at least $250 million outstanding with a weighted average maturity of at least 1 year. One cannot invest directly in an index.

Bloomberg Barclays Aggregate Index: A broad base index, maintained by Bloomberg L.P. since August 24th 2016, and prior to then by Barclays which took over the index business of the now defunct Lehman Brothers, often used to represent investment grade bonds being traded in United States.

NAV: Net Asset Value, i.e. the value of the Fund's assets minus the value of its liabilities

Yield To Maturity: Anticipated rate of return on a bond if held until the maturity date

Par: Face value of a bond. It is the amount paid to the holder at maturity

Correlation: Statistic measure of how two securities move in relation to each other.

SEC Yield: A standard yield calculation developed by the Securities and Exchange Commission (SEC) that is based on the most recent 30-day period covered by a fund's filings with the SEC. The yield figure reflects the dividends and interest earned during the period, after the deduction of the fund's expenses.

Effective Duration: Calculation for bonds with cash flow variability. It takes into account that expected cash flows will fluctuate as interest rates change.

Empirical Duration: Calculation of a bond's duration based on historical data (change in price for a given change in yield to maturity).

Morningstar Proprietary Ratings reflect risk-adjusted performance as of 6/30/2017. The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history, without adjustment for sales loads. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating™ for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating™ metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. As of 6/30/17 the Semper MBS Total Return Fund received a 5-Star Overall Morningstar Rating™ and 5-Star 3-Year Morningstar Rating™ among 259 non-traditional bond funds. The rating is specific to SEMMX and SEMPX and does not apply to other share classes of the Fund. The Semper Short Duration Fund received a 5-Star Overall Morningstar Rating™ and 5-Star 3-Year Morningstar Rating™ among 134 ultrashort-term bond funds. The rating is specific to SEMIX and SEMRX. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating metrics.

Past performance does not guarantee future results.

Unsubsidized SEC Yield: 4.94%

Diversification does not guarantee a profit or protect against a loss in declining markets. Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

Operator: Ladies and gentlemen, thank you for standing by. At this time, I would like to welcome everyone to the Semper MBS Total Return Fund Quarterly Call. The views expressed on this call are the current views of the participants, and are not intended as a forecast or as investment recommendation. Any information provided with respect to the fund is as of the date described and is subject to change any time.

Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original costs. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month-end may be obtained by calling 855-736-7799.

After the speaker's remarks, there will be a question and answer session. To ask a question, please press star and the number one on your telephone keypad. To withdraw your question at any time, please press the pound key. I will now turn the call over to Greg Parsons of Semper Capital Management.

Greg Parsons: Well, I want to start off saying thank you for calling in to our quarterly call. My name is Greg Parsons, and I'm the CEO of Semper Capital Management and I'm joined on today's call by Tom Mandel, co-founder of the firm and a senior portfolio manager within the Investment team.

As we've done historically, Tom and I plan to spend 15 to 20 minutes providing an update on the Semper MBS Total Return Mutual Fund – a mortgage-focused mutual that Semper launched in July 2013. Frankly, I have to say, the last four years have flown by.

Today, we'll break the call into three parts. First, an update on Semper, and what we're seeing in the old raw markets. Second, we'll provide an update on the fund, and then an overview of our outlook. And last, we'll open up to questions.

As many of you know, Semper is a privately-owned asset management platform that focuses our efforts on opportunities within the structured credit space, specifically residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), and asset-backed securities (ABS). Our AUM at the firm level is now over $1.5 billion, and expands a range of structured credit strategies that include absolute return, total return, and index-based solutions and our skill set is available across multiple product formats, to include institutional separate accounts, private funds, and public funds.

This fall, I'm proud to say, we'll cross the 25-year mark since our founding in '92. And the platform is as strong as it's ever been, with respect to people, resources, products, and we believe our distinctive positioning within the space will allow us to continue to capitalize on opportunities for our clients and partners.

Now, let me share some of our current thoughts related to the opportunity we continue to see in market. First, even at today's levels with most non-agency MBS at or close to pre-crisis tights, we continue to see opportunities to drive value on both in absolute and relative basis within the credit sensitive portions of the structured credit universe. Strengthening real estate credit fundamentals, the structure of the market, and strong technical factors continue to work together to create what we believe to be one of, if not the best source of risk-adjusted returns in the fixed income markets. With respect to credit fundamentals, home price appreciation has continued at its very strong pace with the first half 2017, and continues to beat virtually all expectations. Meanwhile, home affordability remains high compared to historical affordability levels.

Second, as the universe of these legacy assets continue to season, and the overall credit quality, the residential real estate space continues to improve, we see growing opportunities for a nimble, opportunistic strategy to invest in attractively valued securities in mortgage assets. While the legacy in non-agency RMBS market is now roughly $500 billion in size, and we think might present challenges to some of the larger players in the space, Semper continues to be able to aggressively navigate opportunistically within the space, and find opportunities to put money to work. Our size, both at the firm level and at the fund level, allows us to take advantage of these opportunities that many of our competitors can't access.

Third, our sector remained extremely well-positioned within the fixed income landscape, with respect to interest rates and price volatility. The fund's performance and positioning, not only during the post-election rate rise, but up through the recent Fed news, and now the 10 year bouncing between 2.2% and 2.4%, has continued to validate this perspective and belief. Our performance remained positive throughout the rapid rise in rates, remained positive during the subsequent drop-in rates, and has remained positive during recent rate choppiness.

To summarize our views to the high level, we believe that the mortgage credit sector continues to offer an extremely advantage-yield profile, low duration on an absolute and relative basis and low correlation to other fixed income assets, based on the continued improvement of real estate and credit. All these continue to make RMBS a great diversifier, and offer the potential for a higher risk adjusted return within a larger portfolio.

I now turn the call over to Tom to talk about more specific about the fund.

Tom Mandel: Adding to Greg's comments about legacy RMBS, we've also been increasingly focused on this next generation of mortgage credit, mainly, by finding ways through newer products, which largely access post-crisis mortgage credit. This includes the newer and developing markets of Agency Credit Risk Transfer, Single Family Rental securitizations, RMBS 2.0, and Non-Performing and Re-Performing mortgages. These have added more diversification to our positioning as we continue to position in the legacy product and it introduces positioning in newer credit, stronger structure in some cases, in many cases, and mortgage underwriting, and I'll talk a little bit more about this.

In another week, we're going to be crossing the four-year mark for the Semper MBS Total Return Fund, as Greg said, it went fast. Performance has continued positive and fairly steady, a carryover from the last four or so quarters. The fund continues to have its 5-star rating from Morningstar, which its had since crossing the three-year mark within the non-traditional bond-fund universe, which is made up of 259 funds over that time period. We saw a continued growth during this recently ended quarter, with assets rising by about a $150 million or 20%, getting us to about $930 million at month end, and we continue to estimate that the fund has another $2 billion of incremental capacity. As we've stated before, the fund's primary investment strategy is investing in mortgage securities with a target minimum of 80%, and our primary sector concentration, once again, is legacy non-agency RMBS, but as I mentioned newer issue non-agencies are growing in importance.

The second quarter of 2017 was another good one for risk assets, and essentially all markets. The Fed raised their target Fed Funds rate again in June, the second for the year, and once again the market took it in stride. The 10 year treasury started the quarter at about 2.4%, and ended at about 2.30%. Today, it's about 2 ¼%.

The Bloomberg Barclays Aggregate Index, which is the broad measure of the overall domestic investment grade bond market, returned 1.45%, and the Bloomberg Barclays MBS Index, which is the fund's benchmark index, returned 87 basis points during the quarter.

Turning to fund performance for the second quarter. The institutional class return 1.86%, net versus the 87 basis points for the MBS index, an excess return about 1%. Year-to-date, the institutional class has returned 3.48% versus 1.35% for the index. And for the trailing 1 year, the institutional class has returned 6.99% net, versus -6 basis points for the index. And then finally, annualized firm inception July 22nd of 2013 through June 30th, net performance of the institutional class was annualized 7.39% versus the MBS index annualized return of 2.81%, which is an excess return of just over 4.5% per year on average.

The fund's total rate of return has been positive for the last 16 months and for 45 of this 47 months since the fund’s inception, which is a little bit over 95% at the time, in contrast to the index, which has been positive less than 3/4 of the time. The primary source of positive performance during the second quarter, once again was interest income, with contribution of about 1.3%. Prices rose about 3/4 of a percent on average during the period. And price gains were fairly well-spread across the sectors that we’re invested in. Realized gains contributed about another 30 basis points, and the largest contributor to realized gains were in the small balance commercial sector and in the subprime sector of RMBS. The dividend yield for the quarter, annualized, was approximately 5.4%, and the share price for the institutional share class, which began the year at $10.58, ended the quarter at $10.66 and is up another couple of basis points since month-end.

Greg Parsons: Just to add to that, in our view, one of the most valuable characteristics of the sector we are investing in in combination with our strategy and approach, is the lack of volatility in the fund share price, as well of the underlying bond prices. The fund’s NAV has been moving up slowly and steadily, there really been only a couple of temporary 1 basis point dips along the way. Performance for the three months for the institutional class was 66, 55, and 64 basis points. So, not a great deal of dispersion across the month.

Tom Mandel: OK. Next, let me go over the composition and structure of the fund. So, as of the end of June, non-agency RMBS made up 69% of the portfolio, which is up several percent from March. And that consists of about an 18% allocation to prime bonds, an 11% allocation to Alt-A bonds, which is lower than it was at the end of March, a 15% allocation to subprime – also a reduction from the end of March, a 23% allocation to NPLs and other 2.0 deals, 10% allocation to Option ARMs, and then a 22% allocation to Credit Risk Transfer or CRT deals. That represents the single biggest change, which is an increase versus the prior quarter-end.

In non-agency CMBS, we had a 16% allocation. About 1/3 allocation to small balance commercial securities, asset-backed allocation was 13%. About 1/3 of that was in Single-Family Rental securitizations, and then 1% cash balance and that cash balance represents a material decrease from the approximate 5% we had at the end of the prior quarter.

Our cash target is now under 3%, and that’s because of the much better liquidity that we have been seeing with our allocation, in particular to these newer issue sectors. We’ve now allocated approximately 40% of our RMBS allocation to this next generation of mortgage credit securitizations. We believe that this positioning in agency CRT and others carries many structural and fundamental value opportunities for us, and the non-performing or NPL and re-performing or RPL deals that we’ve been participating in, allow us for newly-structured enhanced positioning, yet remaining in legacy mortgage credit. These contributed a little bit over half of our returns during the prior quarter, and continue to a primary focus for our positioning going forward. Not the least of the benefits of many of these structures, in particular, the senior classes of the CRTs is liquidity, and the ability to sell many of these bonds with very thin bid/ask spreads has allowed us to reduce our cash position, and to ensure appropriate liquidity for investors. As of June 30th about 7% of the portfolio was made up of these bonds that we’re currently categorizing as cash alternatives because of their liquidity.

The legacy non-agency market’s tone and settlement were generally solid throughout the quarter, both in terms of market participants, and narrower bid/ask spreads as liquidity continue to improve overall. We continue to see a number of eager buyers led by real money investors, and with yields still fairly scarce in other sectors, and we believe a growing expectation for rising rates, especially in the front and of the curve, holders are happy to continue to hold onto this paper, and it's aggressively bid when it's offered for sale. At the same time, we do continue to see plenty of bonds available for purchase through, primarily, through bid lists.

I want to mention, there's been one important development in this legacy RMBS market. So as the market has continued to do better over this past couple years, there has been a growing risk, in particular last few months, a growing risk of some bonds being called, which of course can limit price appreciation for bonds that would otherwise be able to trade significantly above par. So, because of that, we've actually been selling this paper for the last few months. In June, however, 20 deals that were called, for which Wells Fargo is a trustee, we saw something a little bit different. Rather than paying investors a hundred cents on the dollar, Wells Fargo set aside some of the deal balances, on average about 17%, as reserves for litigation expenses. This initially resulted in senior bonds receiving as much as 30% less than expected, and subordinated notes receiving as low as zero. Now, while it's much too early to know what the ultimate outcome will be, we do expect this to create some volatility in the sector, and it's created a little bit so far, which we are confident is going to lead to some great opportunities for us.

Our overall tactical strategy remains the same as a quarter ago. With the credit spread compression that we've been seeing along with this flattening in the credit curve in the space, we continue to think that it's imprudent to be taking less risk in anticipation of inevitable weakness and subsequent opportunities that we think we're going to see. So we're continuing to focus on higher-quality cash flows with more liquidity, with less rate sensitivity, and hopefully with continued lower risk correlations to other risk assets. So, we continue to take the opportunity to sell some of our less liquid profiles, some of our longer spread duration profiles, and we've been focusing on adding the most liquid securities with the least downside risk, which has been the primary driver of our increased allocation to CRTs and to the NPL senior cash flows. That said, the gross adjusted yield to maturity of the portfolio has remained above 5% and of course, dividends have remained over 5% annualized. In fact, the portfolio's loss adjusted yield to maturity at the end of June, we calculated as 5.09%.

Turning to duration, while the 10 year has remained in a trading range over these past few months, we've continue to keep effective duration of around 1 1/2 years, but empirical duration of our portfolio remains lower than that. It's more like 1 year. We have not seen material interest rate driven price movements in most of our portfolios, and we expect that to continue to be the case.

In our view, this low interest rate sensitivity that our fund has demonstrated, adds to the attractive diversification that this sector provides within fixed income. With rates still low and with durations so long in many other sectors, any rising rates will clearly have an increasingly negative impact on much of the bond market, and we believe that mortgage credit can provide one source of stability while generating current yield.

The average dollar price of the portfolio at the end of June was 91.5, similar to a quarter ago. The average price of the RMBS portion of the portfolio was 92. Prime paper was at about 81. Alt-A also was at about 81. Subprime, average dollar price of 89. And CRT paper trading with an average dollar price of a bit over par. The average price of the CMBS that we own is 94.

A couple of other characteristics: We continue to have a great deal of diversity across vintages. And again, what's a little bit different over this past quarter, or so, is with more new issue paper, now about 75% of the portfolio is either pre-2005 vintage, or 2005 and newer. 50% of the portfolio remains invested in senior securities, which of course provides credit support, has credit support from structurally subordinated bonds, which are in the first loss positions. 60% of the RMBS that we own, and 55% of the overall portfolio is floating rate, which is just a little bit higher than a quarter ago.

And of course, we've now had 4 rate increases, which has resulted in many of these bonds' coupons rising by about 1%. This, of course, strengthens the fund's cash flows, and also helps to support the prices of these bonds with floating rate characteristics, and will do so as long as credit quality can support these higher mortgage payments.

We also believe that some of the legacy borrowers are being nudged by these higher rates to begin to seek refinancing, and we have seen refinancings pick-up in the subprime space over this past year, of course, that means we're getting paid a hundred cents on the portion of the bonds that are trading below par.

Turnover during the quarter was active on an annualized basis, about 150%, which is a little higher than it had been the prior couple of quarters. We frankly saw a bunch of opportunities to add value, in addition to selling some of the callable paper, and buying some more of the new issue paper that I talked about. And we continue to have the opportunity to realize gains across the portfolio.

Trading activity remains, and will remain an important part of our investment strategy. We increasingly believe that our size, very small compared to other fund managers, remains a significant advantage in this market. We're convinced that we are right-sized, and we think that advantage will grow over time.

The fund remains long only, with no leverage or hedges in place. We have no plans to change that. We will remain very comfortable with the level of credit risk that we're taking, and in our view, both liquidity risk and interest rate risk continue to be favorable in the portfolio.

In terms of liquidity, we continue to maintain the borrowing facility from U.S. Bancorp, our fund custodian and administrator, equal to 20% of AUM, which we can only use for redemption purposes.

I mentioned the loss adjusted yield to maturity of 5.09% at the end of June. The yield for the RMBS portion of the portfolio, is approximately 5%, and CMBS, approximately 7%.

And then finally, looking forward, we increasingly believe that both the legacy and new issue non-agency RMBS sectors are the place to be in the near to intermediate term. This continues to develop into a relatively high yielding space with continued low correlation of other asset classes, and we believe we'll be well protected in most scenarios. If rates rise from today's levels, we expect these bond prices to remain stable, thanks to their low duration and credit support and we've seen evidence of this several times over the last 4 years during the brief periods of rising rates we have seen. And in contrast to that, the overall bond market has a duration of about six years.

Alternatively, if a risk-off scenario develops, although we do expect some positive correlation between RMBS and other risk assets, we believe these bonds will hold that much better just like it did back in the first quarter 2016 and given the significant credit improvement that we continue to see over the last year, this correlation is likely to be even lower.

Within mortgage credit, of course, there is a range of spread durations, a range of risk that we can take and spread duration is a measure of how much price should change, given a change in credit spreads, and we've actively kept ours on the shorter side, given our view on how flat the credit curve has become.

The credit quality of homeowners continues to increase. HPA or Home Price Appreciation has continued to be above 5% over this past period and this fundamental strength has allowed subprime mortgage refinancings and volunteer prepayments to rise. And again since we own this paper at a discount, it's accretive to performance.

One question that we've heard a lot about over the last few months is home affordability, and as Greg mentioned, given that home prices are back to where they were in 2006, and the bottom line is that home affordability is still very attractive. It's still significantly better than it was pre-recession. So, from a financial standpoint, the sector's underpinnings continue to strengthen.

Talking about liquidity again for a moment, it again continues to be one of the very important risk factors in the fund, and liquidity has continued to improve in legacy paper. It's become very good in the newer issue paper. So, we believe the liquidity remains much more than sufficient for our investment strategy, but we do continue to manage this actively.

So, beyond legacy non-agency which we continue to like with a definite preference for higher quality structures, we also like senior CRT and NPL bonds for the liquidity, as I've mentioned. Their subordinated classes also become increasingly interesting as demand in trading activity has grown and as we've seen, their collateral performed very well. In fact, there've been a number of upgrades in the CRT space.

Across other sectors, we remain constructively cautious in CMBS, and we certainly do see some issues offering good value. Floating rate CMBS new issuance has been in great demand, which we think is a reflection of the market's expectation for yields at least on the front of the curve. We remain very cautious about the agency sector. This $6 trillion sector remains a bit dangerous, in our view, with relatively low yield, relatively long duration, of course negative convexity, so basically one assumes a great deal of prepayment and interest rate risk. Of course, the sector continues to be an excellent source of quality and liquidity, but in general, it's not attractive to us at this point. We do think that the Fed is going to begin tapering its balance sheet over the next few months, and we think that will provide some incremental pressure on spreads in that sector.

So, to summarize, we're going to continue position the portfolio with low duration, with higher liquidity, with limited spread duration, so that we can target, hopefully, a solid monthly return largely driven by interest income, while managing downside volatility. And at the same time, continuing to have the flexibility to buy and trade opportunistically as the market prevents. And again, we think that our size allows us to be nimble, and we think that's going to be increasingly valuable in this market.

So, we think that this combination of yield, rate insensitivity, and improving credit fundamentals will continue to position the fund well going forward within this universe of bond funds, as well as, specifically, within the non-traditional bond fund category.

And thanks for your time, and I'll pass it back to Greg.

Greg Parsons: Great, Tom, I appreciate it.

The fund has crossed $950 million today, up another 20% than the last quarter, and we've been extremely robust business development pipeline on the go forward basis. We're excited as ever about the opportunities that we are seeing in the market to drive value. And I want to thank those on the phone specifically who are already investors for their support to date.

I'd like to mention, if you go to our fund website www.semperfunds.com, you can find a great deal of information about our views on the market, along with stats about our mutual funds, including our Short Duration bond fund. This fund is another 5 star fund in the Morningstar, ultra-short bond fund category. You'll also see info there on our firm website about some very important initiatives that we as a team support including many veteran programs and housing programs. If there's anything we can be providing you or telling you, please let us know. And at this point, we'll open up for questions.

Operator: Ladies and gentlemen, at this time, if you would like to ask a question, please press the star followed by the one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster. There are no audio questions at this time.

Greg Parsons: Well, great. Again, thank you, everyone who joined the call. The information is obviously available by transcript on our website. We look forward to continuing to provide the skill set as it serves. Thank you.

Operator: Ladies and gentlemen, this does conclude today's call. You may now disconnect.

END