Chandler Asset Management

An Investor's Perspective on the Contracting Agency Sector

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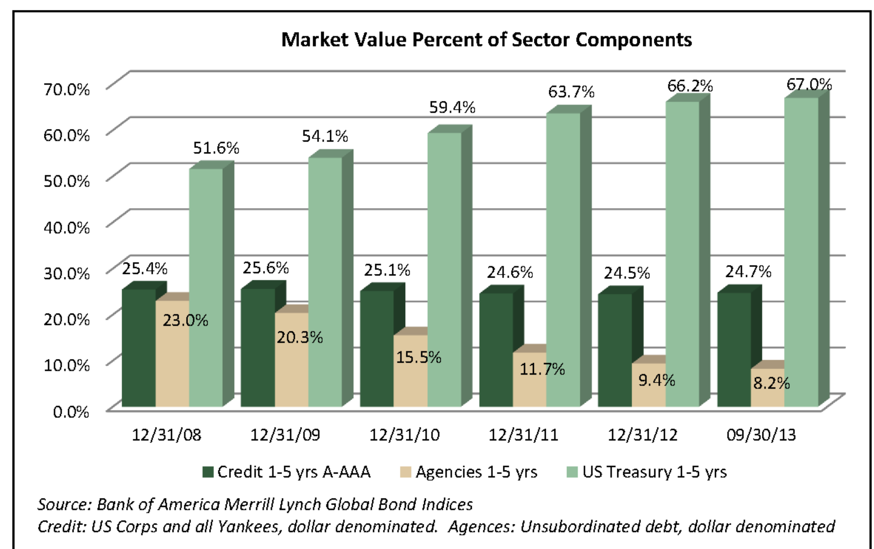
Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios.

Chandler's mission is to provide fully customizable, client-centered portfolio management, which preserves principal, manages risk, and generates income in our clients' portfolios.

Five years since the historic announcement by the US Treasury in September 2008, Fannie Mae and Freddie Mac remain in conservatorship, essentially a division of the US Treasury. The conservatorship status served to shore up investor concerns about the credit worthiness of both Fannie Mae and Freddie Mac and yields on their respective securities responded in kind. How to ultimately wind down the aforementioned Agencies has been a controversial topic within the United States government since the financial crisis. Many proposals have been put forth by both the President and Congressional leadership over the past several years but a clear end-game is not yet evident. The latest bipartisan proposal, titled Housing Finance Reform and Taxpayer Protection Act of 2013, was put forth by Republican Senator Bob Corker and Democratic Senator Mark Warner on June 25 of this year, but little progress has been made since. Both Fannie Mae and Freddie Mac remain an integral part of the mortgage market despite the impact of the conservatorship status has had on each. We do not anticipate any legislation gaining enough bipartisan support to wind down the Agencies over an intermediate time horizon (3-5 years).

At Chandler, we focus our investment process around three tenets: safety, liquidity, and yield, in that order. Many of our clients have investment mandates that require them to invest in securities that have a final maturity of less than five years. To illustrate the changing market dynamics, particularly in the Agency sector, we analyzed a time series of three high quality market indices in the 1-to-5 year maturity range to better illustrate how the market has evolved (see chart).

The Agency sector of the market has decreased materially, currently representing only 8.2% of the respective market benchmarks (as of 9/30/13) versus 23.0% on 12/31/08. The Credit component of the benchmark has held relatively stable, while the Treasury portion has increased from 51.6% of the benchmark as of 12/31/08 to 67.0% as of 9/30/13. Historically investors have gravitated to the Agency sector of the market to pick up a modest amount of incremental yield and potential return with a negligible uptick in credit risk. Chandler Asset Management is not beholden to the Agency sector but rather is an advocate of having a diversified portfolio that includes an allocation to the three above mentioned sectors as well as other fixed income assets that meet the tenets of safety, liquidity, and yield. In the past, we have written about the benefits of the Credit sector (see January 2012 article, Investing High Quality Portfolio in a Low Rate Environment and September 2012 article, Considerations for Moving Down in Corporate Credit Quality) and still find the overall yield benefit of the credit sector compelling, however the focus of this article is concentrated on the Agency sector.



Source: Bank of America Merrill Lynch Global Bond Indices
Credit: US Corps and all Yankees, dollar denominated. Agencies: Unsubordinated debt, dollar denominated

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The team at Chandler broke down the components of the Agency 1-5 Year universe into two primary components, non-callable (bullet) versus callable issuance (see table below). We theorize that due to the insatiable demand for Agency securities coupled with the decreasing amount of supply the Agency sector is able to issue securities that investors may be mispricing, particularly in the more complicated callable component of the market. The table does not incorporate all Agency issuance available, but rather the focus is only in the index eligible deals (minimum 250m in par). We acknowledge there is substantial issuance that does not meet the minimum index inclusion criteria however in practice we would also argue the smaller deal sizes negatively impact liquidity from an investor's perspective.

As of 9/30/13 the bullet component of the Agency universe was 76.1% versus 23.9% for the callable component, the highest amount of callable securities in the universe since 12/31/08 but below the 25.9% as of 12/31/07. Based on the data set provided callable issuance has been on a modest upswing as we would argue Agency issuers find the callable market attractively priced. In our view, the Relative Comparison portion of the table provides some valuable insight investors need to be cognizant of. In six of the seven periods cited, an OAS (Option Adjusted Spread) advantage is evident in the callable component and in all seven periods the callable component has a higher effective yield versus the bullet universe. Typically, a wider spread and greater yield would over time produce a total return advantage, but based on the index return data this is not the case in all seven periods cited. In all periods, the total return from the bullet universe is greater than the callable universe.

BofA Merrill Lynch 1-5 Year Agency Indices	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	09/30/13
GVPB (1-5 bullet)							
# issues	194	298	315	280	262	238	237
Full Market Value	448,277	623,667	740,470	691,745	555,270	495,453	436,912
Effective Yield	3.71	1.59	1.59	0.94	0.61	0.44	0.72
OAS (vs govt)	54	81	19	13	26	7	12
Effective Duration	2.34	2.45	2.37	2.26	2.41	2.63	2.62
% total	74.1%	81.6%	77.6%	79.4%	78.1%	79.1%	76.1%
YTD return	7.814	8.628	2.528	3.536	2.617	1.522	(0.079)
GVPC (1-5 non bullet)							
# issues	316	265	350	363	338	315	335
Full Market Value	156,509	140,452	214,194	179,610	155,917	131,165	137,125
Effective Yield	3.84	1.85	1.67	1.25	0.74	0.46	0.83
OAS (vs govt)	64	107	69	23	38	5	15
Effective Duration	1.02	0.51	1.31	1.71	1.31	1.37	2.05
% total	25.9%	18.4%	22.4%	20.6%	21.9%	20.9%	23.9%
YTD return	6.001	4.836	2.136	1.238	1.668	0.845	(0.117)
Relative Comparison							
OAS Advantage (callable vs. bullets)	10	26	50	10	12	(2)	3
Effective Yield Advantage (callable vs. bullets)	0.13	0.26	0.08	0.31	0.13	0.02	0.11
YTD Return Advantage (callable vs. bullets)	(1.813)	(3.792)	(0.392)	(2.298)	(0.949)	(0.677)	(0.038)

Source: Bank of America Merrill Lynch Global Bond Indices

Other data in the table help us confirm that investors need to be especially vigilant in evaluating callable securities so as not to be susceptible to chronic underperformance versus bullet securities. We highlight a few data points of particular interest:

- 12/31/09 - Despite an OAS advantage of 50 basis points to callable securities the following year the total return of the callable universe was 2.298% below that of the bullet universe.
- 12/31/10 - Despite an effective yield advantage of 0.31%, the following year the callable universe underperformed the bullet universe by 0.949%.
- 9/30/13 - The effective duration of the callable universe increased to 2.05 versus 1.37 at year end, highlighting the extension risk of the callable universe and implying investors heavily exposed to the callable sector were likely constrained to buy cheaper fixed income assets when the markets re-priced yields wider in the 3rd quarter of 2013.

Chandler is not advocating that a high quality portfolio have zero exposure to callable securities. In practice, the team has had a difficult time identifying securities that are attractively priced relative to the potential extension risk embedded in a callable security and we think the data presented above supports that conclusion. Chandler continues to advocate well diversified portfolios by sector, credit quality, and structure, and we caution investors about the negative implications due to the changing demand and supply dynamics of the Agency sector.

William Dennehy II, CFA

SVP, Portfolio Manager

William Dennehy is a Senior Vice President and Portfolio Manager at Chandler Asset Management. He is responsible for implementing portfolio strategy and securities trading in client accounts and also leads the firm's Credit Committee.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

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