

Asset- and Mortgage-backed Securities: A Primer

By Jonathan Carlson, CFA

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With high credit ratings, potent diversification benefits and attractive yields, asset- and mortgage-backed securities are widely used by the managers of liquidity portfolios to achieve attractive risk-adjusted returns. In the Q&A below, Jon Carlson, head of separate account management at BofA Global Capital Management, describes the mechanics of these securities and the benefits they can offer cash investors.

What is securitized product? Does it describe a particular product or a family of securities, i.e., an asset class?

Asset- and mortgage-backed securities — ABS and MBS, respectively — are created by lenders to convert relatively illiquid loans on banks' balance sheets into liquid, tradable securities. Securitization — the process through which these loans are converted into these tradable, liquid credits — enables banks to free up capital for additional lending and to reduce their credit exposure. As their names imply, ABS and MBS derive their value from the pools of consumer loans backing the securities. In the case of ABS, those bonds generally are backed by credit card debt and auto loans; for MBS, the collateral is mortgage loans. It is the performance of these loans, along with the nature and functioning of the credit enhancement that typically is incorporated within ABS and MBS, that determines the performance of these securities.

How are ABS and MBS structured?

In the case of MBS and ABS backed by auto loans, thousands of loans are grouped into “buckets,” with each bucket containing loans with similar characteristics — similar credit quality, similar maturity dates, similar interest rates, etc. Those loans are sold into a bankruptcy-remote trust, which issues notes that are sold to generate the funds used to purchase the loans backing the notes. Because of the diversity of loan characteristics (credit quality, maturities, variability and timing of cash flows, credit enhancement, etc.), the securities have very different risk/return profiles,

which allows investors with different risk tolerances and return objectives to capture the potential benefits of ABS and MBS.

In describing the structure of ABS, you highlighted securities backed by auto loans. What about ABS backed by credit card loans?

With credit card-backed ABS, the credit card company issues all bonds through a single trust, known as a master trust, and the bonds are backed by the issuer's total loan portfolio, not by isolated pools of loans linked to specific issues. So there is no dedicated pool of loans backing individual deals. The entirety of the loans held by the master trust backs all of the bonds issued by that trust over the course of several years. In other words, a credit card-backed bond issued in 2007 is issued by the same trust and backed by the same collateral as one issued in 2009.

What is the difference between ABS and asset-backed commercial paper or ABCP?

In the case of ABCP, the paper is repaid primarily from cash flows generated by pools of receivables, but they also can be repaid from new issuance and, in times of market disruption, by drawing on a liquidity facility provided by the sponsoring institution. In the case of ABS and MBS, it is the performance of the loans backing the securities that determines when investors receive both principal and interest payments. In volatile markets, credit support and deal integrity also impact the return of principal for ABS and MBS.

For investments in ABS, MBS, and CMOs generally, when interest rates decline, prepayments accelerate beyond the initial pricing assumptions, which could cause the average life and expected maturity of the securities to shorten. Conversely, when interest rates rise, prepayments slow down beyond the initial pricing assumptions, and could cause the average life and expected maturity of the securities to extend, and the market value to decline. When prepayments accelerate due to falling interest rates, principal may have to be invested at a lower interest rate than the coupon of this security.

Past performance is no guarantee of future results.

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What is the risk/reward profile of ABS and MBS?

Because we manage cash portfolios, BofA Global Capital Management buys only AAA-rated ABS and agency-backed MBS (MBS whose loans are guaranteed by Fannie Mae or Freddie Mac). With these securities, credit risk is very limited, so we focus on prepayment risk. Simply put, prepayment risk refers to the risk associated with the uncertain timing of principal repayment on the underlying ABS or MBS. ABS structured with a “soft bullet”^{*} feature allows for some variation in the timing of payments to bondholders. For MBS, the variability is a bit greater than that of ABS and stems from the embedded option mortgagees have to prepay their mortgages earlier than scheduled. Investors are compensated for the additional risk presented by the variability of the payments in the form of a yield premium. The issue to consider when weighing a specific ABS/MBS security versus another is whether the yield pickup is sufficient to compensate investors for the risk presented by the soft bullet structure in ABS and the variable cash-flow timing with MBS. That is what we focus on when we screen ABS and MBS for our portfolios.

Why does BofA Global Capital Management incorporate ABS and MBS in its money market funds and other liquidity portfolios?

We like ABS and MBS because their risk/return profile meshes well with our investment philosophy, which, put briefly, is that the management of liquidity portfolios should reflect the two most important responsibilities of liquidity managers — protecting investors’ principal and ensuring that investors have access to their assets no matter how challenging the market environment. ABS and MBS support us in those efforts because they offer very high credit quality and they are very liquid. In addition, they pay a yield premium to compensate investors for the variable timing of cash flows we discussed earlier.

You said credit risk was not a major issue for the AAA rated ABS that we purchase or for MBS, but wasn’t MBS a major contributor to the volatility of liquidity portfolios during the global financial crisis?

MBS was painted with a very broad, very negative brush in the wake of the credit crisis. Any bond backed by mortgages

was viewed as excessively risky. The reality is that the problems investors experienced with some MBS during the crisis resulted not from problems with MBS as an asset class, but from the poor-quality loans backing some credits. Many of the problem MBS issues were backed by subprime, alt-a, alt-b and negative amortizing loans, many of which blew up as the housing bubble deflated. MBS issued and guaranteed by government agencies suffered no credit losses, performed as expected, and retained their liquidity during even the worst of the credit crisis. ABS as a sector did suffer losses and illiquidity in 2008, but the bonds we invest in — high-quality auto- and credit card-backed securities — outperformed their riskier peers and continued to trade well during the financial crisis.

How have the ABS and MBS sectors changed since the credit crisis?

Prior to the financial crisis, Wall Street firms became ever more creative in finding ways to slice and dice the cash flows coming off of the loan trusts, and ABS and MBS credits became more esoteric and difficult to analyze. After the credit crisis, the emphasis was on quality and simplicity. Today ABS and MBS are more straightforward and easier to analyze. As a result, they’re also even more liquid than they were before the credit crisis. We project that these simpler structures will continue to prevail in upcoming years as the markets mend from the financial crisis. However, we could see more exotic, more complex structures in the future if concerns about stability and liquidity are eclipsed by the desire for higher yields. That shift, if it happens, would put a premium on the sophisticated due diligence necessary to effectively screen ABS and MBS.

^{*}Soft Bullet- Bullet structures are designed to return principal to investors in a single payment. The most common bullet structure is the soft bullet, so labeled because the bullet payment is not guaranteed on the expected maturity date, in which case investors may receive the remaining principal payments over an additional period.

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Jonathan Carlson is a director and head of portfolio management for liquidity strategies separate accounts at BofA Global Capital Management. Mr. Carlson joined a former Bank of America affiliate in 2007 and has been a member of the investment community since 1988.

Prior to joining Bank of America, Mr. Carlson was the head of the core bond strategy and the mortgage-backed securities teams at Merganser Capital Management, with substantial client, prospect and consultant interaction.

Previously, he led portfolio managers on several segments of the general account at CIGNA and was a mortgage strategist with client interaction. During his tenure at Scudder, Mr. Carlson filled a variety of roles, including portfolio manager and team leader, portfolio manager mortgage strategist on the mutual fund side of the organization, and portfolio manager and mortgage strategist on the institutional insurance side of the business. Prior to that, he was a stable value portfolio manager at State Street and a bond analyst at the Federal Reserve.

Mr. Carlson earned his B.A. in economics and English from Amherst College and earned his M.B.A. in finance from Northeastern University. He holds the Chartered Financial Analyst designation and is a member of the Boston Security Analysts Society.

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