We sat down with Sam Dunlap, portfolio manager at Angel Oak Capital Advisors, to discuss the current climate of the non-agency Residential Mortgage Backed Securities (RMBS) market, the impact of a ratings upgrade on the overall non-agency RMBS market, and how Angel Oak’s mortgage strategies could benefit from changes in the market. Sam leads the RMBS investment team for both the Angel Oak Multi-Strategy Income Fund and the Angel Oak Flexible Income Fund. He also creates portfolio strategies within the RMBS space, and manages Angel Oak funds’ exposure to interest rate risk.

Q: Provide a brief history on the evolution of the non-agency RMBS market from the early 2000s to today. For example, how large was the market then versus today, and what are the differences in the quality of the underlying collateral?

A: Outstanding legacy non-agency RMBS market, at its peak, prior to the credit crisis, was approximately $2 trillion. Of that $2 trillion in outstandings, approximately 90% of the marketplace was rated AAA. Today, there is approximately $626 billion outstanding of legacy non-agency RMBS, and 81% is rated below investment grade. We would break today’s market down into the following four current subcategories:

1. Alt-A, which consists of approximately $180 billion outstanding or 29% of the marketplace
2. Subprime, $226 billion or approximately 36% of current outstandings
3. Prime, $140 billion or approximately 22% of the current outstandings
4. Option Adjustable Rate Mortgages (ARM), which consist of approximately $79 billion, or 13% of current outstandings

As you know at Angel Oak, we participate primarily in the Alt-A, prime, and Option ARM areas of the non-agency RMBS legacy market.

Q: Compare and contrast how the rating agencies operated in the 2006-2007 time period for the non-agency RMBS market versus today.

A: The methodology of the rating agencies for non-agency RMBS has not changed too dramatically since the crisis, but there are two key differences between pre-crisis and post-crisis ratings. Number one, home price appreciation. In the pre-crisis period, rating agencies assumed that home prices were always going to increase. That assumption has clearly changed in the post-crisis period. The other key difference is fraud. The rating agencies and market participants clearly had a lot of difficulty in modeling the amount of fraudulent loans in the pre-crisis pools, which is very difficult to model. There has been a paradigm shift, though, in the amount of scrutiny that borrowers and originators face to meet regulatory requirements in today’s origination process. Going forward, market participants and the rating agencies should be much more confident in the reduction of fraud in the collateral pool collaborating the quality of their projected scenarios going forward.

Q: Angel Oak Capital mentioned in a recent whitepaper that approximately, “81% of the non-agency RMBS market is still below investment grade, but according to Bank of America-Merrill Lynch non-agency MBS research, Moody's, S&P, and Fitch are preparing for large-scale upgrades of legacy non-agency RMBS.” So the question is, why now, and with a legacy non-agency RMBS market size of approximately $626 billion, what percentage of the market will potentially be impacted by these upgrades?

A: Despite the smaller size of the market, upgrades are increasing really due to improving credit fundamentals. Upgrades of legacy non-agency RMBS began in earnest in 2014 with approximately $10 to $20 billion upgraded per quarter and market participants expect this trend to potentially double over the next couple of years.
Q: So you mentioned fundamentals. What fundamentals are driving the upgrades?

A: The legacy non-agency RMBS market has seen sharp improvements in its valuations due to increasing levels of home equity, illustrated by improving loan-to-value ratios, declining by over 30% since 2012, and the consistent positive trend in U.S. home prices, coupled with an increasing number of voluntary pre-payments and falling delinquencies. Improving fundamental performance should continue to drive the upgrades in the legacy non-agency RMBS market, especially for positions that still have credit enhancement intact.

Q: Do you expect to see an increase in demand for legacy non-agency RMBS?

A: To the extent that the legacy non-agency RMBS market gets upgraded to investment-grade, absolutely. Investment-grade ratings certainly allow more market participants to potentially allocate to this asset class, and there is certainly no shortage of high-quality floating rate assets, particularly in fixed income. There are still a lot of investors that are precluded from investing in below-investment-grade assets, but even without the upgrades, we expect that demand for legacy non-agency RMBS will continue to increase; aside from the ratings upgrade potential, the asset class continues to heal and benefit from the improving fundamentals mentioned above that make it really stand out in the fixed-income marketplace as a high-quality floating-rate potential asset class that should be a part of all fixed-income portfolios in our view, particularly as it relates to the improving credit fundamentals.

Q: How are Angel Oak’s mortgage-focused strategies positioned to potentially benefit from these ratings upgrades?

A: Potentially benefitting from rating agency upgrades in our mortgage strategy has really been a key focus for our funds since inception. We're indifferent from a rating agency perspective, but we selectively -- and have always selectively -- targeted bonds with the potential for credit quality improvement, which should continue to drive credit ratings upgrades. Credit ratings upgrades do provide what we would envision as the next level of price appreciation and potential spread tightening beyond where current spreads are in the marketplace, and enhance the potential total return for our non-agency RMBS allocation across the entire legacy non-agency market. The majority of the upgrades, though, are expected to be in sub-prime collateral, and as I mentioned earlier, most of our holdings are in prime, Alt-A, and Option ARM bonds, but the key is, our strategies and what the bonds we target exhibit very similar characteristics to the sweeping upgrades that are expected in the sub-prime marketplace, and still provide the potential for future upgrades in our opinion. Approximately 40% of our funds’ allocations to non-agency RMBS in our view has the potential to be upgraded at some point in the future. Of that 40%, we expect approximately 33% has the potential to be upgraded to investment-grade over the next couple of years.