

DWIGHT ASSET MANAGEMENT COMPANY

TIMING IS EVERYTHING

Protecting Non-Agency Mortgage-Backed Securities From Declines in the Housing Market

Median home prices in some markets have risen dramatically, which has caused some observers to worry that a sharp correction is imminent. For example, home prices in the Pacific states (AK, CA, HI, OR, and WA) increased an average of 19.2 percent over the last 12 months and 81.5 percent over the last five years. Historically, housing recessions have not occurred in isolation. Most real estate recessions have been caused by regional job losses and rampant oversupply. However, given the megaboom state of many housing markets, home prices during this cycle may decline without the normal catalysts. An examination of past recessions indicates that home price declines could be significant (see Figure 1).

Even though national median prices have never declined, certain regions have exhibited volatility. Therefore, diversification would seem the best method to minimize the risk of a real estate bubble deflation. From a practical perspective, however, many diversified mortgage pools can still have 20% to 40% of their portfolios exposed to California, one of the most overheated housing markets, so concentration is also a consideration.

Location, Location, Underwriting, and Servicing

In terms of mortgage-backed bonds, the old adage regarding location should include underwriting and servicing. Real estate loans from the same geographic area can perform differently by underwriter. During the loan origination process, underwriting procedures can differ greatly in terms of borrower credit analysis and, more importantly, *property appraisal reviews*. During a real estate recession, properties with inflated appraisals at the time of loan origination will experience not only higher loss severities but also higher default frequencies. Default probabilities correlate highly with homeowner equity.

The quality of the underwriter and servicer matters not only at the time of origination but also over the life of the loan. Loan-loss mitigation requires significant financial resources and seasoned risk managers during a market of declining or flat home prices. In today’s home real estate market of double-digit appreciation, financial markets differentiate little among originators. Diligent research that recognizes prudent underwriters and well-capitalized servicers will amply reward investors in the future.



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Figure 1: Historical Changes in the Median Price of Homes

	Cumulative Price Decline (Peak to Trough)	Duration	Maximum 1-Year Price Decline During Recession
Boston (beginning 3Q89)	-9.6%	3.1 years	-7.7%
Houston (beginning 2Q82)	-33.2%	5.5 years	-10.2%
Los Angeles (beginning 1Q90)	-26.1%	6.5 years	-9.0%
New York (beginning 4Q89)	-6.0%	1.8 years	-4.7%
San Francisco (beginning 1Q90)	-12.9%	4.8 years	-4.9%
National Market	None		+1% Appreciation

Source: Freddie Mac

Portfolio Strategies

Favor Seasoned Loans

A portfolio of seasoned loans will benefit from the escalation in home prices. The equity buildup in seasoned loans should protect against losses even during a housing recession. Unfortunately, prepayments have been common as interest rates have declined, and only a limited amount of seasoned product remains. Accordingly, investors must also seek alternative investments.

Overweight Highly Rated Bonds and Short Average Life Bonds

The default function of a real estate portfolio is not binary. Instead, default experiences in a portfolio of real estate loans typically occur along a loss curve with losses generally peaking in years three and four, as seen in the mortgage pool loss curve in Figure 2.

Even if a real estate recession materializes in the next several months, investors in short average life ▶▶

Timing is Everything, continued

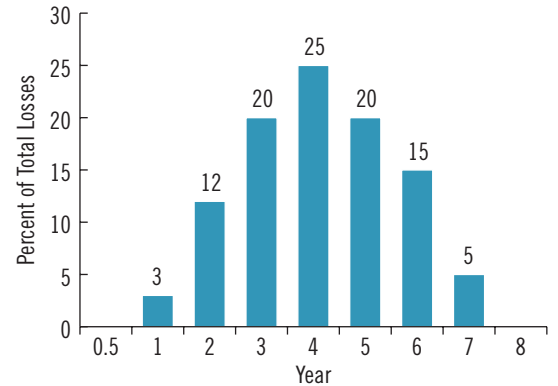
- ▶ bonds should perform well. Conversely, investors in the longer average life, last cash flow bonds will have much greater exposure to delinquencies and defaults that occur during the peak loss period.

Seek High-Coupon, Premium Dollar-Priced Securities

A slowdown in the housing market would increase defaults and decrease prepayments. Premium bonds from prime mortgage collateral (loans from the most creditworthy borrowers) benefit from slower prepayments. The improved performance from slower prepayments should more than offset increased losses from defaults. However, because lower interest rates would increase prepayments, the conservative approach would be to ensure that premium bonds comprise only a small position in a portfolio.

A defensive portfolio should also limit exposure to securities rated less than AAA. Default modeling of newly originated collateral suggests that while lower-rated mortgage bonds may not default, they may face downgrades. BBB/Baa bonds, for example, are normally rated to protect against two times expected losses. However, even under a base scenario of home price appreciation slowing to 5% by the end of 2005, loss coverage falls below two

Figure 2: Non-Agency Residential Mortgage Pool Loss Curve*



Source: Moody's Investor Service
*Based on subprime mortgage pool. Prime mortgage pools have had virtually no losses.

times. Only under the assumption that home prices continue to appreciate at rates similar to those of the past five years (ie, 8% per year) would BBB/Baa bonds maintain their ratings (Figure 3).

Loss Coverage Protection Analysis

Loss coverage protection is the multiple of the default curve where the bond has the first dollar loss of principal.

Below are the basic home price appreciation scenarios for Figure 7:

- *Meltdown*: -5% for each of the next 3 years, +5% thereafter
- *Pessimistic*: 0% for the next 3 years, 5% thereafter
- *Base*: Home price appreciation slows to 5% annually by year-end, 2005
- *8% for life*: Average over last 5 years
- *Aggressive*: 11% for life

Like any component of the capital markets, timing is everything. While the current state of the residential real estate market dictates prudence, investors who take a defensive stance too early will risk underperforming the market. However, with the increase in warning signals seeming more like the tech bubble of the late 1990s, the cost of ignoring the risks of a correction in the housing markets could be far greater to the non-agency mortgage market. As always, over the long run, a cautious and disciplined approach is most likely to reward investors. ■

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Figure 3: Loss Coverage Protection Ratios for Non-Agency Mortgage Securities

Original Rating	Home Price Appreciation Scenarios				
	Meltdown	Pessimistic	Base	8% For Life	Aggressive
Ba2	0.6	0.7	0.9	1.2	2.4
Ba1	0.7	0.8	0.9	1.3	2.8
Baa3	0.7	0.9	0.9	1.4	3.2
Baa2	0.8 (Ba2)*	1.1 (Ba2)*	1.1 (Ba1)*	3.6 (A3)*	4.8 (A1)*
Baa1	0.9	1.2	1.2	4.8	
A3	1.0	1.4	3.1		
A2	1.1	1.6	4.1		
A1	1.2	1.8	6.2		
Aa2	1.5	2.7			
Last Cash Flow Aaa	3.6				
3-Yr Sequential Aaa	6.5				
Mezzanine Aaa	2.4	6.0			
Super Senior Aaa	6.2				

Source: Lehman Brothers

*(Resulting Rating Coverage Ratio)

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