CMBS: Finding Value in a Volatile Market

Jason Golder
Vice President
Portfolio Manager: CMBS

Commercial mortgage-backed securities (CMBS) continue to be a core investment component within Dwight-managed strategies. Given recent volatility, it is important to take stock of our holdings and methodology when it comes to trading within the CMBS sector.

Recent Market Events

The year began much like 2008 ended, as investors concentrated on the deteriorating economy and the subsequent weakness in the commercial real estate market. Jittery consumers increased savings and decreased spending, leading to retail weakness that manifested itself in various bankruptcies and store closings. Large empty spaces that resulted from Linens 'N Things and Circuit City closings not only hurt the image and rent capacity of store space, but in certain instances these closings also led to contractual contingencies allowing surrounding retail tenants to demand lower lease payments.

Meanwhile, continued weakness in the finance industry led to a consolidation in banking, brokerage, and ancillary businesses that has contributed to consolidation of office space. This decrease in demand for office space has crept into the strongest markets of New York City and Chicago. Headline loans such as Peter Cooper Village/Stuyvesant Town and the Riverton Apartments were aggressively underwritten and predicated on regulatory concessions and the ability to increase rental rates in the future. Economic weakness and legal issues have contributed to the headwinds facing the cash flow projections underlying these loans.

On the positive side, the government has introduced more details of their economic stimulus plan, and CMBS is now in the mix. The market has rallied as investors have some hope that the CMBS market will get a boost from public and private funds helping to "normalize" pricing. Currently the lack of willing lenders has made pricing for new loans or refinancing far too onerous, locking up the market. Government aid may help buyers and sellers of commercial real estate find a level at which new loans can be generated and the refinancing of current loans can be completed. This would allow good properties to function in a consistent manner and eliminate the need for forced sales that depress the values of commercial real estate.

The Case for Security Selection

There are two significant ways for a sector portfolio manager to measure performance in the world of fixed income; how the sector will perform compared to the universe of bonds, and how the securities selected will perform versus the rest of the sector and the universe at large. In past economic cycles CMBS has tended to be a lagging economic indicator. We expect the sector to continue to show weakness after the economy begins to recover, and we therefore continue to favor security selection as our preferred means of performance.

When Dwight analyzes CMBS bonds, we look at several factors:

1. Deal Structure: Dwight invests primarily in conduit and fusion CMBS transactions. These deals consist of many commercial real estate loans that are pooled together in a trust, which is then divided into tranches that provide various cash flows. The cash flows are usually broken into senior tranches that receive prepayments and take the first planned principal and interest payments. Within this block, additional tranching allows for different cash flow tenors, and furthermore, breaks out different types of cash flow (amortizing versus balloon payments). Below these senior tranches are the mezzanine and junior tranches that support the senior pieces and provide a measure of over-collateralization. The mezzanine and junior tranches pay interest and principal in a waterfall pattern (one class receives all scheduled principal and then the next begins to pay, etc.). In periods of heightened volatility, Dwight looks to invest in the senior tranches that provide the most protection in the waterfall. By investing in these tranches, we accept the first claim on

continued on the following page

principal and are protected from defaults and losses by the mezzanine and junior tranches.

2. Seasoning: We generally look for bonds that were originated prior to 2005. While there are performing loans and solid securities from 2006-2008, we have generally found value in earlier vintages. One reason for this is that loans underwritten before 2005 were on properties that experienced some price appreciation prior to the high-water mark in 2007 and 2008. This limits the downside of property depreciation we have seen during the last two years. The earlier vintage loans have also had time to "cure." Many of these loans have experienced amortization or voluntary principal prepayment so they currently have lower loan balances and in a distressed sale would still hold some value. Finally, the underwriting standards prior to 2005 were much more stringent. Fewer loans were underwritten based on pro-forma assumptions that included relying on future rent increases. Relying on real, measurable rent payments is preferable to projections that ultimately may not materialize

3. Loan-Level Detail: In any deal it is important to look at loan stratifications. We look at the deal's weighted-average loan to value, debt service coverage, amount of interest-only loans, delinquencies, tenant concentrations, state concentrations, and amount of defeased or disposed debt, among other factors. We also look at the types of loans. In a volatile environment, it is often preferable to own trophy assets in large, well-supported markets as opposed to certain depressed assets in tertiary markets.

4. Relative Value: When evaluating two bonds we may, under certain circumstances, purchase the bond with less-appealing characteristics if the price creates a positive risk/return profile. If a 2007-originated bond is priced at thirty cents on the dollar, the depressed price and subsequent high yield may provide more positive risk/return characteristics than the deal structure and seasoning of a 2003 bond priced at ninety cents.

Conclusion

We expect commercial real estate fundamentals to continue to deteriorate as a result of economic weakness. We also expect CMBS loan performance to lag the overall economic cycle and remain weak for some time after the economy begins to recover. Nevertheless, we continue to believe that the CMBS sector provides relative-value opportunities. Concentrating on sector selection allows Dwight to hold solid credits that can survive widespread economic stress while providing the opportunity to benefit from a sector rebound resulting from government intervention or otherwise. We will look to concentrate in bonds that are higher in the capital structure and tend to be more seasoned, while also seeking deals that contain solid properties and structural protection. Weakness in the sector has already been largely priced into the market and many very good bonds carry distressed-dollar prices. Strong analysis and process can yield bonds providing solid carry and principal-upside potential relative to other sectors in the fixed income universe while managing the risk to our portfolios.

For more information:

Fixed Income & Stable Value
Greg Prisk
Executive Vice President
802.383.4104
gprisk@dwight.com

David Richardson, CFA
Managing Director
802.383.4024
drichardson@dwight.com

Insurance
Donald Hill
Senior Vice President
802.383.4062
dhill@dwight.com

John Loud
Vice President
802.383.4047
jloud@dwight.com

Consultant Relations
Lisa Trubiano, CFA
Senior Vice President
802.383.4066
ltrubiano@dwight.com

Anicia Mendez
Vice President
802.383.4067
amendez@dwight.com

100 Bank Street
Suite 800
Burlington, VT 05401
802.383.4000

One SW Columbia
Suite 1720
Portland, OR 97258
800.929.4427

www.dwight.com