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Absolute Return + Alpha

Cerberus mortgage chief: Investment opportunity a "perfect storm"

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Josh Weintraub talks to AR about the RMBS market.

Josh Weintraub (Photo: Cerberus)

Mortgage investing is one of the hottest hedge fund strategies, with dedicated funds launching and large multistrats allocating in large numbers. Fittingly, it has been the best performing strategy in the industry so far this year: hedge funds that employ an MBS strategy are up an average of 6.43% through June, according the AR database. That compares to a composite return across all strategies of 2.65%.

AR asked Josh Weintraub, head of RMBS securities and trading at Steve Feinberg's $20 billion Cerberus Capital Management, to discuss the firm's approach to RMBS investing and opportunities in the market. Weintraub—who will be speaking at the upcoming Absolute Return Symposium—directs the Cerberus RMBS Opportunities Fund, which has grown to $1.17 billion as of July 1 after launching in August 2011 with $188 million. The fund is up 7.79% net of fees for the year through June, according to investor materials obtained by *AR* (Cerberus declined to discuss fund performance).

***AR*: What's the RMBS opportunity today?**

Josh Weintraub: There's been a huge upheaval in the U.S. residential housing market in recent years. While we've seen a mild U.S. economic recovery over the past several years, the U.S. residential property market remains distressed with nearly one in four owners underwater on their mortgages and a significant overhang of vacant homes for sale.

As financial institutions clean up their balance sheets by pricing anticipated defaults or selling off distressed mortgage-backed securities, we expect to continue to see opportunities to invest in the immediate future. The fact is that there remain more sellers than buyers in the distressed RMBS markets, and investing in these securities requires a significant amount of expertise. Pricing inefficiencies and the high barriers to entry have created an environment for knowledgeable investors to benefit from long-term macroeconomic trends in the U.S. housing market.

Why has there been such a high level of interest in your new RMBS fund?

While we don't discuss fundraising or returns, we believe that there will continue to be opportunities in this market for some time, and investors are realizing that a seasoned team of investment experts in this specialized area is necessary to understand and invest in these complicated securities.

What is driving the opportunity in RMBS?

We see two major drivers here. First, the amount of distressed RMBS securities available remains high. Second, current stresses in the U.S. housing market are overshadowing its impending recovery.

In a typical market, you would expect to see buyers line up to take advantage of the RMBS selloffs from financial institutions and the Federal Reserve and that the pricing of the securities would recover relatively quickly. However, the RMBS market has been different. You have to remember that Fannie Mae and Freddie Mac – which had been the two largest buyers of mortgage-backed securities – have been placed in conservatorship and are not buying at their traditional levels. Second, the lack of proprietary trading desks and less risk-taking appetite in the broker dealer community limits competition. Lastly, the lack of strong credit ratings on the bonds reduces demand from banks and insurance companies, who typically need investment grades. As a result, there is limited buying which is keeping pricing down.

Consider this fact. In the U.S. housing market, in recent years it has never been cheaper to own a house versus renting. Rents continue to rise relative to home prices, and excess supply of housing is slowly but steadily being reduced. As household creation continues to outpace the supply of new homes, we'll begin to see upward pressure on home prices accelerate. Ultimately, that pressure and ongoing financings will be priced into these securities, but the market doesn't currently reflect this improved outlook. There are also many opinions out there that the massive amount of shadow inventory and stress at the servicers will elongate the recovery. The various views create uncertainty and opportunity.

What are some of the risks?

Understanding the complexities of these securities and the individual mortgages that back them is fundamental to succeeding in this market. A number of variables can greatly affect outcomes such as the level of borrower prepayments, delinquency behaviors, loss recovery scenarios and public policy risk. Being a successful RMBS investor requires not just the knowledge to identify mispriced securities – which is a difficult task in and of itself – but also the expertise and discipline needed to take risk off. Over the last few years we have seen major pricing volatility which has allowed profit taking and replacement trades.

Having said that, we think that this is the perfect storm where there are more sellers than buyers so prices are weak, but the fundamentals in our view are pointing to a U.S. housing recovery. We are targeting sectors in the U.S. RMBS market where loan performance is expected to outperform market expectations even without an improvement in housing or the economy. And a mild rebound in housing will have a major impact on returns.

The borrower left in the pool today has real staying power, as they have been resiliently paying their mortgage even though they may be underwater. In some securities Cerberus is buying, collateral performance is actually stabilizing or improving rather than deteriorating. Yet the underwriting is still at historically depressed levels and the improvements are not priced in. From a downside protection perspective, when we stress the scenarios to draconian levels, we find that these securities should still yield low single digits which is good compared to U.S. Treasurys or other high quality fixed income products.

How do you select securities?

Four years ago, Steve Feinberg and senior management at Cerberus had the foresight to build a team of mortgage specialists to take advantage of this rare investment opportunity. Cerberus built a team of specialized investment professionals who understand the fundamentals of these securities. The team of specialized RMBS professionals was fully integrated into Cerberus' platform of PE investment managers and other distressed teams. Cerberus has a long history of distressed investing, and Steve Feinberg started his career as a distressed trader. Steve and the other investment professionals outside of the RMBS team add a ton of value in providing a global and domestic macro view in understanding consumer behavior, investor rights, policy initiatives, industry analysis, and overall development of an investment thesis.

When you combine the Cerberus global platform with RMBS specialists, you attain a very powerful base to make investment decisions. Our investments are fully vetted before we commit capital. We will analyze borrower behavior including their likelihood of default, refinance or if they will simply continue paying. We look at industry effects and policy initiatives that can affect these outcomes. Then when our thesis is developed we will hand pick each security a bond at a time. Through bond selection we try to generate alpha and reduce our beta. Purchasing securities can take advantage of the underlying loan performance while reducing some of our downside and increasing our upside through the capital structure. Lastly, we try to create a diversified portfolio to try to eliminate idiosyncratic outcomes and create more likely performance in a variety of scenarios.