Let's Go to the Mall.....for Now

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The extended period of easy money has made finding good investment opportunities considerably more difficult, but these opportunities do exist. There is too much cash trying to find a home. Larger investment firms have been focused on the limited new issue deals coming to market which is their easiest way to invest larger pools of funds. This demand has caused many new issue deals, both for corporate bonds and structured product bonds, to be oversubscribed, keeping market spreads tight. Following this market herd is likely to produce minimal gain and could actually put investors at risk when rates do begin to increase and spreads start to widen. Migrating to floating rate instruments may alleviate some of this risk, but this still exposes investors to the risk of lower yields if there is a prolonged period before rates begin their upward journey.

Profitable investment opportunities often are found by looking where investor fears have caused capital voids. One market sector this year that continues to be shunned is CMBS, particularly in the retail space. There has been an increasing avoidance of retail collateral over an extended period as brick and mortar locations have lost ground to digital shopping. We shared these same concerns regarding retail based CMBS and over the past several years and had shifted away from retail heavy CMBS conduit deals towards bonds with multifamily exposure such as the non-agency guaranteed tranches of Freddie-K deals. Freddie-K deals are FreddieMac issued deal structures based on multifamily collateral such as apartment buildings. The "A" tranche is typically agency guaranteed while the "B' and "C" tranches do not carry an agency guarantee for timely payment of principal and interest.

In early 2020, the closing of malls during the onset of COVID greatly magnified the already existing investor apprehension towards the retail sector. BBB-rated CMBS yields went from 3.5% in early March 2020 to 9.5% by mid-May. The COVID panic response by many investment managers was to jettison retail exposure to meet margin calls and fund outflows. This produced many buying opportunities during the early stages of the epidemic that continue today but are less frequent. In response, we have gradually reduced our underweight exposure to retail CMBS since the onset of COVID to capitalize on market fears by supplying liquidity to this market sector.

Overall, BBB-rated CMBS yields are now back to their pre-COVID levels. However, the market's fear of the retail space continues to scare investors as they digest 2020 financial reports showing drops in net operating income (NOI) and lower occupancy. Fear generates opportunity. A key concern is to avoid a possible trap of investing in bonds exposed to retail space that may decay in the longer term from the continued pressure of retail transactions migrating to the digital world, regardless of COVID. We are negative on the retail space in the long term because of this dynamic, but in the short run, we are positive on the sector and see opportunity. As COVID isolation dissipates, many people are looking to get out and socialize. A trip to a shopping mall is one way to accomplish this. Mall foot traffic increased by 86% in May 2021 from a year earlier, but still is 24% below March 2019 levels. The increased traffic should be a positive force in the near-term supporting malls and other physical brick and mortar retail shops.

We utilize multiple factors to find just the right deals that have many levels of protection and match our outlook on the CMBS sector. We consider loan to value (LTV), debt service coverage ratio (DSCR), occupancy, credit enhancement, weighted average life, NOI trends, servicer advances, payment histories and other characteristics to make investing decisions in this space. It may require sorting through a dozen bonds before we identify one with promise. We then utilize our internal credit model that risk weights individual loans based on their characteristics to determine what overall safety margin is available before the bond in question realizes its first loss.

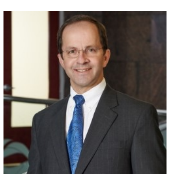
The bonds we select have shorter weighted average lives to avoid the longer-term negatives we see in the brick and mortar retail sector. We also select bonds paying large coupons which provide additional protection in situations where the underlying loans have difficulty refinancing and extend beyond their original maturity dates. The opportunities we find typically come from 2011-2014 legacy conduit deals. These deals typically have larger coupons since they were originated not long after the 2008-2009 housing financial crisis when investors had to be drawn back into the financial markets with higher yields. These older deals also have had enough time for property price appreciation which lowered their LTVs and improved the safety margin that we seek. Since many of the loans in these older deals are also nearing maturity, these bonds will have lower weighted average lives which helps avoid longer term exposure to the retail space.

I will review a typical 2012 vintage conduit CMBS bond we recently added to our portfolio which is currently rated A- by S&P and BBB- by Fitch. The deal collateral consists of 28 loans all of which have been current for the past 48 months with a composition of 19% defeased, 32% anchored retail, 19% mixed use, 15% office and 8% hospitality. The non-defeased collateral has a 1.5 DSCR, 77% occupancy and a 55% LTV (44-64% range). The tails of the LTV distribution are important in that they can skew the perceived safety margin if an investor views the embedded risk simply by the weighted average LTV. The actual safety margin is driven by the highest LTV loans in the pool which are most likely to incur a loss. This bond's collateral pool also has 4 loans with a combined $8.1 million of servicer advances that must be considered.

Our sample bond has an attractive 4.7% coupon that provides 39 bps of monthly income that can easily offset financing costs if the collateral loans have difficulty refinancing at maturity and extend. The deal structure provides 15.2% of credit enhancement (18.8% on a defeased adjusted basis). Our internal models indicate that after paying off all servicer advances, the overall property values on a risk adjusted basis can drop by 56% before any loss is incurred by this bond. This is more than ample to cover any liquidation transaction costs.

Bloomberg's BVAL valuation for this bond is currently $91.5 which is near where we acquired this bond. Prior to the COVID crisis, this bond was priced near par. The valuation dropped to $60.5 by mid-April 2020 after the COVID market shock and then recovered to an $82 price level by the end of 2020. The current $91.5 valuation at a 0% CPY prepayment rate results in a 1.15 year weighted average life bond yielding 12.84% (1,265 bps spread to the swap curve) considerably more than the 4.91% yield of the BBB rated CMBS component of the Bloomberg Barclays Aggregate Bond Index. Our bond's lower weighted average life also results in our bond having lower interest rate risk than our respective benchmark component. Note that the 8.5% price discount provides an additional buffer against any potential losses that may be suffered by this bond.

This approach serves us well in acquiring solid investment grade bonds producing double digit yields in the current low yielding market that contains very limited profitable opportunities. It provides a nice placeholder for our capital in the shorter term with a possibility of higher market yields when it comes time to redeploy our capital upon maturity if market rates increase in the interim.



Karlis R. Ulmanis, CFA, Portfolio Manager, is responsible for managing fixed income sector weight strategies and mortgage portfolios. Mr. Ulmanis is responsible for development, implementation and execution of mortgage and corporate investment strategies and for fixed income sector allocation strategies. Prior to joining DuPont Capital in 1997, he served as Vice President and Manager of Quantitative Research at Fidelity Federal Bank, and Vice President and Senior Investment Analyst at First Interstate Bancorp. Before beginning work in the financial services industry in 1993, he served as Senior Project Engineer for Hughes Aircraft Company.

Mr. Ulmanis holds a B.S. in Mechanical Engineering from the University of Illinois, an M.S. in Aerospace Engineering from the University of California, and an M.B.A. from the University of Southern California. He is also a CFA charterholder.