

Subprime Bonds Are Back

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As Economy Recovers, Long-Term Investors Willing to Take On More Risks

Subprime and other residential mortgage bonds that helped trigger the financial crisis are back in vogue with long-term investors, in the latest sign that American credit markets are healing after the worst downturn in a generation.

The prices on a representative slice of the subprime bond market have doubled from 30 cents on the dollar at the low point of the crisis to roughly 60 cents today.

Their comeback underscores how investors have regained the courage to take on more risk as the economy recovers, pushing up the prices of a broad swath of riskier assets, from commodities to junk bonds to stocks.

On Thursday, the stock market ended its best first quarter since 1999, with the Dow Jones Industrial Average closing up 6.41% on the quarter. A positive first quarter bodes well for the full year, with the market posting annual gains 81% of the time.

Growing Attraction

The ABX index, which tracks prices of subprime mortgage bonds, has recovered since the crisis.



Note: ABX.HE.AAA.06-2 sub-index
Source: Markit

The attraction of bonds underpinned by subprime home mortgages is fat yields, at a time when the Federal Reserve has pushed interest rates on the safest investments to among the lowest levels in history. In addition to subprime bonds, conservative investors are re-entering the market for other so-called nonagency bonds, which means they aren't backed by Fannie Mae or Freddie Mac. These securities yielded close to 20% during the downturn, and are now fetching between 5% and 7%—still well above roughly 3.5% yields on U.S government bonds and 4% on high-quality corporate bonds.

The willingness to take on risk is helping ordinary borrowers, too, by leading banks to make more nontraditional loans, such as jumbo mortgages, and to charge lower interest rates for them. Since the worst of the crisis, the extra amount that borrowers have had to pay for these loans has fallen by half, with interest rates for jumbo loans now roughly 5.5% compared to 5% for 30-year conforming loans. The extra amount over standard conforming loans that a person would have to pay for a jumbo has fallen from 1.3 percentage points to a bit over 0.5 points.

Equally notable, investors say, is that prices on these risky bonds have stabilized in recent months, giving conservative buyers the confidence to step in.

The demand is so strong for these securities that even the Federal Reserve is taking advantage, announcing Wednesday that it will sell off billions of dollars worth of subprime mortgage bonds it took on as part of its bailout of American International Group Inc. (NYSE: [AIG](#) - [News](#)) in 2008.

Subprime bonds are securities backed by hundreds or thousands of loans to homeowners with spotty credit profiles.

The sellers are often hedge funds and other investors who scooped up the beaten-down debt and want to lock in gains after a two-year rally. Current buyers say banks are now willing to lend them money so they can buy more of these bonds, a sign both of banks' increasing willingness to lend and the change in view among investors about the safety of nonagency bonds.

Mortgage bonds still have significant risks. While the U.S. housing market is expected to eventually recover, protracted foreclosure battles and the still-weak economy could mean that cash flows that investors expect the bonds to receive could take longer than expected to materialize. Analysts generally view their downside risk as limited at the bonds' current prices, even though delinquency and default rates among the loans backing them remain high.

The market burst into the spotlight in March when an unlikely buyer stepped in: AIG, the giant insurer that had to be bailed out by the government because of its own bad bets on subprime mortgage bonds.

AIG offered to buy back a pool of bonds that the Federal Reserve had taken off its hands during the crisis. AIG's \$15.7 billion offer for the bonds, which have a face value of \$30 billion, spurred other investors to consider making offers.

Citing "improved conditions" in the market and "a high level of interest by investors," the Fed on Wednesday rejected AIG's offer and said it would begin selling off these mortgage holdings, letting investors bid for pools of bonds and individual securities so the central bank can maximize its profits.

At least four large life insurers, among the most conservative of all investors, are eyeing the subprime bonds the Fed plans to sell, according to people familiar with the matter.

Gary Madich, chief investment officer for fixed income at J.P. Morgan Asset Management, said his firm has been a buyer of these types of bonds and would be interested in buying some of the assets the Fed is selling. "Getting an opportunity to look at a portfolio like this in the secondary market is exciting and appealing," he said.

But even before AIG's offer to the Fed, other typically conservative investors such as real-estate investment trusts were buying these bonds.

"I would not say we are back to the old days," said Scott Robinson, a senior vice president at Moody's Investors Service. But some investors are snapping up such assets because "cautious optimism and relatively high capital levels has resulted in some re-risking of balance sheets."

MFA Financial Inc. (NYSE: [MFA](#) - [News](#)), a publicly listed company that invests in mortgage bonds, has been buying since the market stabilized, doubling its holdings in 2010.

Last year, MFA was buying \$100 million worth of the bonds a month. Recently it boosted its buying to \$300 million a month. Early in March, it raised \$500 million by selling stock so it could buy so-called "prime" and "alt-a" bonds, which are bonds backed by mortgages taken out

by borrowers with generally better credit than subprime borrowers. MFA is buying more now because it's easier to get funding from lenders who, they say, are less worried about the risks.

Invesco Mortgage Capital Inc., a real-estate investor, has also ramped up, raising \$460 million last week, in part to buy these types of bonds in a real-estate trust. It raised \$870 million last year and is borrowing against that to invest more, says chief financial officer Donald Ramon.

Most of the subprime bonds still have "junk" credit ratings, and most are not expected to ever return to their original values. But several changes that have taken place over the past two years are encouraging traditional investors to take a second look at the assets.

In the wake of the financial crisis, state insurance regulators implemented changes that effectively reduced the amount of capital insurers have to hold against many residential mortgage securities, if those securities are bought at a sharp discount to face value. Insurers thus are now finding it economical to buy subprime bonds.

Besides paying relatively high interest rates, many subprime bonds pay floating interest rates—so, when rates eventually rise, they should also benefit. Traditional fixed-rate bonds lose value when interest rates rise. The Federal Reserve is widely expected to begin boosting interest rates early next year.

Hedge funds still account for roughly half the trading volume in these securities, according to research from Deutsche Bank. But some hedge funds with the stomach to buy the bonds at their lows are now done with the trade.

Nick Krsnich, who started an investment firm for these types of bonds after leaving mortgage lender Countrywide Financial Corp. as its chief investment officer about five years ago, liquidated a \$150 million portfolio earlier this year after generating average annual returns of 50%. The current yields, he says, are too low for him.