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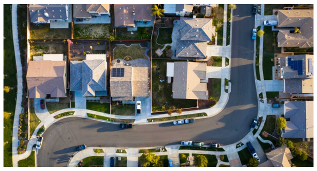

A Bullish View on the Mortgage Industry

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As the saying goes, "Generals are always prepared to fight the last war." Much like military strategists tend to look back and focus on tactics that worked in past conflicts, investors often place too much weight on risks that were at the heart of the last financial crisis. In U.S. corporate credit markets, this tendency has led to many opportunities in the financial sector since 2008. In that vein, we find the high yield bonds of certain non-bank mortgage originators and servicers to be a compelling opportunity today.

The Bear Case

While we are unabashed bulls, let us start with the bear case. From the second quarter of 2020 through the first quarter of 2021, both volumes and margins in mortgage originations were at record levels as demand far outpaced capacity. However, as interest rates began to rise in the spring of 2021, volumes declined. Suddenly, there was excess capacity. At the same time, the two largest mortgage originators began competing fiercely with one another and the rest of the industry. Volumes and, even more so, margins fell rapidly.

For many investors, the scars from the global financial crisis have not yet faded. They have not forgotten that the mortgage market was at the epicenter of the crisis, and non-bank mortgage originators were decimated. Our own mantra at that time was "stick to deposit-funded lenders only." Why get involved now in a cyclical and competitive industry with excess capacity and a price war between the two largest originators?

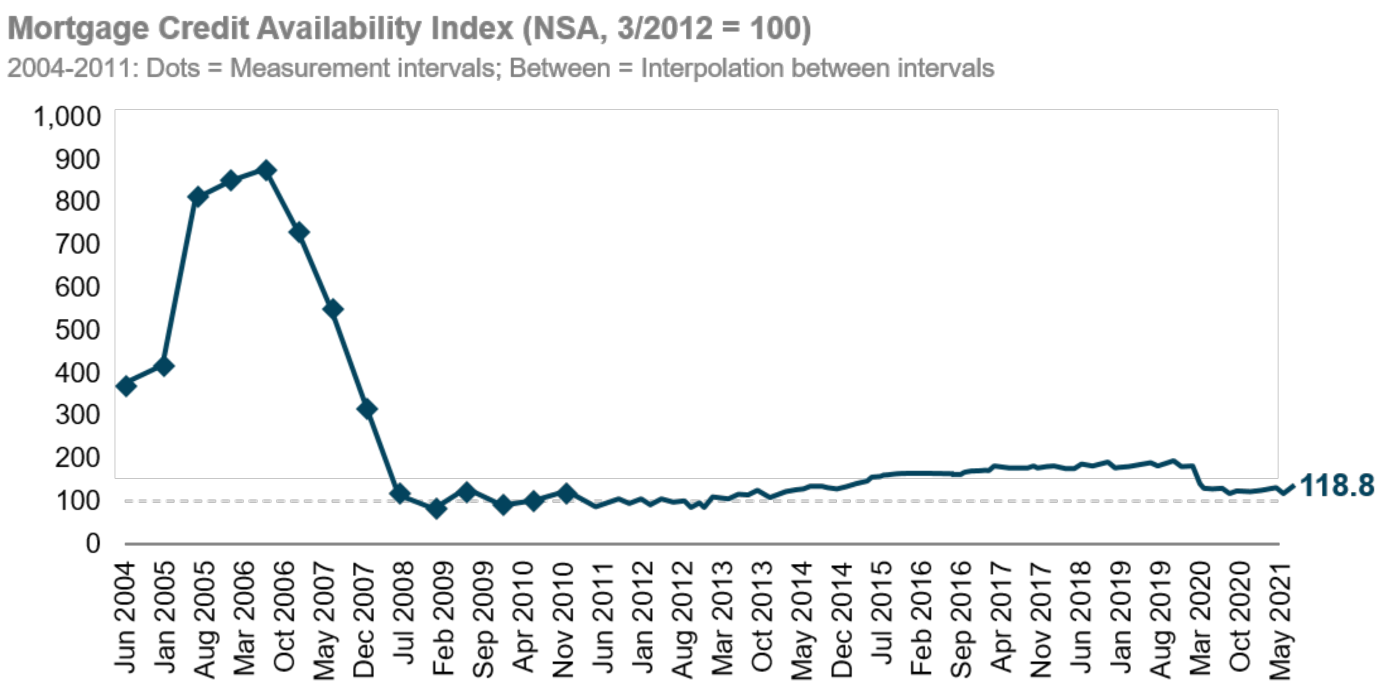
The Bull Case

Let us look at the bull case, starting with the price of the bonds. To paraphrase Warren Buffett, investors pay a high price for a "cheery consensus." The current uncertainty in the mortgage industry has led to bond prices that we believe will lead to attractive returns going forward. However, some corporate bond investors are unwilling or unable to put up with that uncertainty. Some fail to distinguish between issues that are more relevant to equity investors than bond investors who are higher up in the capital structure. The unsecured bonds of four of the larger mortgage companies can be bought at yields between 5% and 7.5% in a high yield market that is closer to 4%.

Since the global financial crisis, there have been several positive developments and increased differentiation among non-bank mortgage originators. Three of the largest non-bank mortgage companies came public over the last year, and most of the larger players now have public equity market capitalizations that are multiples of their corporate debt. Each has unique characteristics. Some are more exposed to refinancings, others to purchases. Some acquire customers directly, others through relationships with mortgage brokers, realtors, homebuilders, and financial service providers. Most now have sizable mortgage service books that increase in value as refinancings slow, producing a natural hedge against the origination side of the business. Lastly, most of the management teams are experienced, having been through multiple cycles, including the global financial crisis. We find the valuations to be attractive across the board, but a finer understanding of these differences allows us to take advantage of mispricings within the industry.

A Very Different Mortgage Market

Even if it takes a year or two for earnings to normalize, we believe these companies have the capital, liquidity, and business flexibility to get to that point without undue stress. However, seemingly everything happens much faster these days, and there are already signs that both volumes and margins will be better in the third quarter than the second quarter. As the chart below shows, this mortgage market is very different than the market that imploded during the global financial crisis. Our benchmark-agnostic, high-conviction, long-term approach—one of the hallmarks of our Global Fixed Income team at Brandywine Global—allows us to take full advantage of the compelling values in this industry.



Source: Mortgage Bankers Association; Powered by Ellie Mae's AllRegs Market® Clarity® Data prior to 3/31/2011 was generated using less frequent and less complete data measured at 6-month intervals interpolated in the months between for charting purposes.

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