RICHMOND CAPITAL MANAGEMENT
Experience, Knowledge, Service

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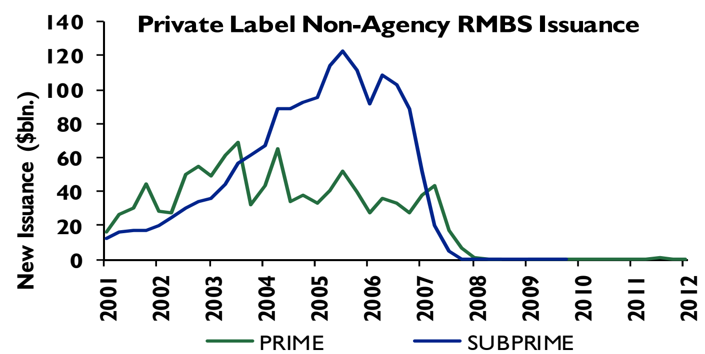
Securitized Markets: Revisited

The securitized bond market, including Agency and privately-labeled residential mortgage-backed securities (MBS) and commercial MBS (CMBS), was a primary factor in the rise in real estate values which helped the economy to grow prior to the financial crisis of 2008. From 2003 to 2008, the annualized rate of growth, as measured by change in the gross domestic product, ranged from 3% to 5% and the unemployment rate hovered at "full employment." Then, in the summer of 2008, it seemed the music suddenly stopped -- all guests at the leveraged securitization party were left standing with no chairs in which to safely sit. The party was over. The downside of the leveraged housing boom was realized by all who had benefitted, from Wall Street to Main Street. Massive wealth destruction and the evaporation of related jobs has been historic and still grips our nation. According to data published by the Federal Reserve, U.S. household wealth fell by 38.8% between 2007-10 - largely due to a decline in the value of real estate owned - highlighting the deep damage inflicted by the housing crash, financial crisis and recession on the U.S. economy.

Will the securitized bond market return to its heyday and help re-ignite our economy or will it lie dormant? More importantly, how have events of the past changed investor behavior when investing in the securitized market? The answers are different for each sector of the securitized market.

Market conditions within the three primary securitized markets range considerably. By a wide margin, the Agency (GSE -Backed[1]) MBS market has fared the best. Despite the short-term event risk associated with both Fannie Mae and Freddie Mac (taken into conservatorship by the U.S. Treasury in 2008) investors have continued to purchase Agency MBS based on the perceived implied government guarantee, liquidity (most liquid after U.S. Treasuries), homogeneity, transparent investment structure, and attractive current yield. In fact, the market and its investor base have grown since the Federal Reserve included Agency MBS into monetary policy initiatives in 2010. The only significant change to the Agency MBS market has been that borrowers must now comply with very stringent underwriting origination guidelines to obtain a conforming loan, necessary for securitization into an Agency MBS pool.[2]

The private-label (non-Agency) residential MBS market which effectively provided unabated capital to prime and sub-prime borrowers for non-conforming mortgages (i.e., negative amortizing, option adjustable-rate, jumbo, interest-only, etc.), went down in flames in the early stages of the credit crisis in 2008, and the burnt embers of this sector still remain undisturbed. **The non-Agency residential MBS issuance market, for the most part, does not currently exist (see chart).**

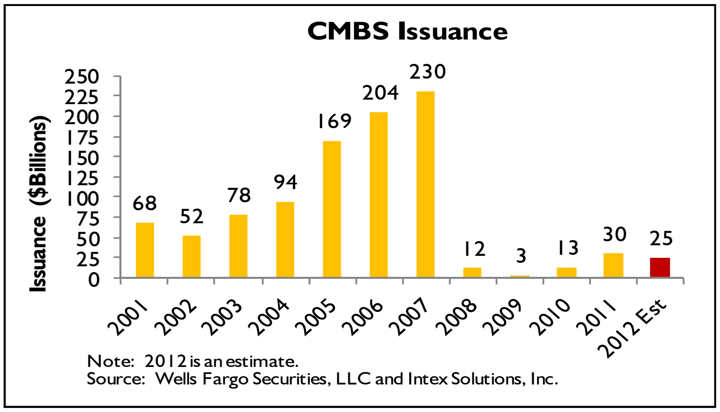


Sources: Wells Fargo Securities, LLC

Similar to the non-Agency residential MBS market, banks and Wall Street firms specializing in the origination, underwriting, and securitization of commercial mortgages capitalized on economic and housing optimism. The issuance of CMBS peaked in 2007 with $230 Billion of securitization only to fall off the cliff to only $12 and $3 Billion of issuance in 2008 and 2009, respectively (see chart on back). Although the underwriting and securitization practices drifted from historical practices late in the cycle, **CMBS are fundamentally different than the non-Agency residential MBS market.**

[1]GSE - Government Sponsored Enterprises (Ginne Mae/Fannie Mae/Freddie Mac).
[2]Conforming Mortgages - Mortgages that conform to GSE guidelines in terms of size, borrower repayment qualifications, and type of property. Conforming mortgages serve as collateral for Agency MBS.

Properties in CMBS transactions include office, retail, apartments, industrial, and to a lesser degree, hotels. These properties produce cash flow from their tenants. The income produced is transparent enabling on-going surveillance of property performance. Loan level financial results can be obtained from independent, third party data providers allowing investors in the CMBS market to monitor and manage risk that investors in non-Agency residential MBS could not. **This difference has helped restore investor confidence in the sector which has recently come to life after its near death experience in 2008.**



Since the value of commercial real estate is the present value of the its expected cash flows (tenant income less expenses) discounted by a market-based discount rate, each CMBS deal can be effectively re-underwritten in real time. It is possible to perform independent credit risk analysis and not have to rely solely on Wall Street firm analysts or rating agency credit ratings. At Richmond Capital Management, we focus on independent research and consequently, we developed a credit model that is used to analyze CMBS securities. Each mortgage underlying the CMBS deal is re-underwritten based on most recently reported property income and expenses. Draconian discount and loss recovery rates are applied to determine worst case potential principal losses to bond holders, if any. The “Margin of Safety” (as shown below) is then computed by comparing the structural subordination (percent of lower-rated bonds available to absorb losses) to the stress test scenario. From the below chart, five separate CMBS deals from 2002 through 2006 were re-underwritten based on property cash flow reported as of May, 2012.

CMBS Deal & Bond	Coupon	Effective Maturity	AAA-Rated Subordination	Delinquency Rate	[----Stress Test----] Projected Losses[1] %	"Margin of Safety"
WBCMT 2002-C2 A4	4.98%	10/15/2012	59.0%	3.2%	-4.8%	**54.2%**
BSCMS 2003-PWR2 A4	5.19%	9/11/2013	24.5%	0.4%	-2.3%	**22.2%**
WBCMT 2004-C10 A4	4.75%	2/15/2014	43.4%	0.0%	-5.9%	**37.5%**
BACM 2005-6 A4	5.37%	11/10/2015	33.9%	4.6%	-14.0%	**19.9%**
LBUBS 2006-C1 A4	5.16%	1/15/2016	30.8%	3.3%	-12.7%	**20.1%**

[1]-Projected Deal Losses Absorbed by Non-Investment Grade Bondholders.

Regardless of whether the securitized markets ever return to their former place in the economic and housing growth engine, investors have clearly understood the term "Caveat Emptor.” The most recent financial crisis lends further credence to our belief that sound, comprehensive, independent security analysis is the best course of action to serve clients and meet their investment objectives.

Fixed Income Data Bank

Index Returns

	Qtr.	1 Yr.	3 Yr.
Barclays Aggregate	2.06%	7.47%	6.93%
Barclays Int. Aggregate	1.32%	5.28%	5.98%
Barclays Govt/Credit	2.56%	8.78%	7.34%
Barclays Int. Govt/Credit	1.48%	5.42%	5.81%
Barclays 1-3 Year G/C	0.22%	1.12%	2.26%
Barclays 1-10 Year TIPS	1.34%	6.26%	7.41%

Source: Barclays Capital *As of June 30, 2012*

Treasury Market Yields

	6/30/12	3/31/12
3 Month	0.08%	0.07%
2 Year	0.30%	0.33%
5 Year	0.72%	1.04%
10 Year	1.65%	2.21%
30 Year	2.75%	3.34%

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