more inclined to look for opportunities after a bubble has burst and others are selling securities indiscriminately. That said, the challenges value investors face when momentum investing is in vogue should not be underestimated. During the tech bubble, for example, value investors underperformed the broad market from 1995 to 1999. The challenge then was to maintain their discipline even as they were losing assets.

From my perspective, one of the most difficult challenges today is to peer inside the black box of the financial system and identify the leverage and inter-connectedness in it. Research by the BIS on bank exposures is particularly useful in this regard. And work now being undertaken by the U.S. Treasury and the Federal Reserve to identify macro-prudential risks should prove valuable.

Still, in the end, investment professionals must make judgments when they do not have complete information. For this reason, my colleagues and I now look at a broad array of market indicators that will provide clues about possible stresses and strains in the system. We also have developed a set of indicators to monitor conditions in the credit markets because they provided early-warning signals leading up to the financial crisis.

Finally, investors were not alone in missing the financial crisis—most economists missed it as well. While the economics profession is only beginning to do its soul searching, some prominent economists are pointing at the failure of models to grasp the importance of the credit-creation process. We must hope that the economics profession will take up the challenge, because it holds the key to assessing potential booms and busts in asset markets.

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Blinded by the Past

HINDSIGHT-DRIVEN ANALYSIS PROVIDES A DISTORTED OUTLOOK FOR THE PRIVATE MBS SECTOR

By William Chudy, CFA

Every article I read regarding credit-rating agencies' ratings for structured products is a backward looking view of what happened nearly a decade ago in the private mortgage-backed securities (MBS) market. For the past six years, the financial press has been strewn with headlines discrediting the credit-rating agencies, analysts demonstrating their perfect hindsight with their critique of the ratings, and details of all the lawsuits yet to be played out in the courts. Many of these stories helped effect great change in the standards, policies, procedures, and transparency with which the ratings for structured financial instruments are applied by each of the major credit-rating agencies. In particular, imbalanced (and frequently redundant) media coverage of the private MBS sector is perpetuating fear, mistrust, and illiquidity. At this point, the financial community should be well aware of the questionable ratings and practices that scarred an entire generation of private MBS investors. What doesn't get nearly as much coverage is any kind of forward-looking analysis on how we can take what we have learned and apply it to current investment practices.

Although we can learn from mistakes of the past, the investment community should be focusing more on the mistakes of the present. In 2006, capital markets became dislocated because only a few participants capitalized on the delta between economic reality and statistical errors embedded in structured-product ratings. Today, however, the pendulum has swung so far in the other direction that AAA should now be re-classified as AAAA. Investors are so fearful the credit-rating agencies still have it wrong that AAA MBS spreads are unreasonably wide. This dislocation is the primary roadblock to replacing Fannie Mae and Freddie Mac with a private market. Investors should understand that the models have changed and the current AAA rating for structured products in the residential mortgage space is not the AAA of 2006.

IS AAA REALLY AAAA?

Many high-caliber analysts do their homework, build loan performance models, and understand macroeconomic probabilities and hedging strategies. These analysts don't need to rely on the credit-rating agencies for anything other than a benchmark against which they deliver alpha. They are generally highly paid for their work, and their resources are not best used in trying to decipher excess returns through expected loan performance of new-issue AAA private MBS. The whole point of the AAA rating is to

TITLE FOR CHART???

Issue	Weighted-Average LTV	Weighted-Average FICO	Percent Full Doc	Interest Only	AAA Support
Sequoia Mortgage Trust 2006-1	69%	739	48%	85%	4.25%
Sequoia Mortgage Trust 2013-1	67%	769	100%	5%	7.30%

Source: US SEC's EDGAR database

create a sense of security that an investor is highly unlikely to take a principal loss. Thus, there is no need for a team of highly paid analysts and statisticians to build the same models deployed by the credit-rating agencies. This sense of trust is what promotes liquidity for AAA securities, reduces borrowing costs, and decreases reliance on the federal government for ensuring stability in the mortgage finance and housing sectors of the US economy. If any knowledgeable analysts want to poke holes in the current private MBS ratings methodologies, their arguments would be well worth reading.

In 2006, a AAA rating for a private MBS was—and still is in 2014—a subjective measure, but between these two vintages, there is a tremendous difference in both the quantitative and qualitative measures. Better understanding and awareness of this difference may cultivate that sense of security that the AAA stamp is supposed to deliver. From a quantitative perspective, it is quite difficult to find comparable securities between 2006 and 2013. Not many issuers from 2006 have issued private MBS since 2008. Very few full-documentation loans were originated in 2006, whereas recent issuances are 100% full doc. Underwriting policies and procedures in the industry were far from homogenous in 2006. All of the differences between the past and present support better credit enhancements for today's private MBS market, but comparing a securitization from each vintage highlights how different AAA was in 2006 versus 2013. Consider a comparison of the credit stratifications from a Sequoia Mortgage Trust Securitization from each vintage with the highest correlation of loss experience along with the size of the support for AAA tranches.[1]

Clearly, this is not your father's AAA. With a lower loan-to-value (LTV) ratio, materially better credit scores (FICO), no stated income ("liar loans"), and far fewer "toxic" interest-only features (by the way, we could also use some media coverage giving some context about the actual "toxicity" of interest only), the 2013 AAA MBS carries 70% more credit enhancement relative to the riskier 2006 vintage security.

What does 7.3% AAA support for today's MBS securitization profile mean? Without turning this into a research report, it is fairly easy—thanks to the availability of historical loan-performance data—to make some high-level comparisons. Simply take the primary credit attributes, make conservative assumptions, and overlay the historical performance on today's origination profile. For example, using data from CoreLogic (a data and analytics company), we can take a conservative approach and overlay the loan performance of "ALT-A" MBS from the 2006 vintage with the current credit profile to see how new-issue MBS would hold up if new originations were to experience a similar environment. Stratifying US$55 billion of full-doc amortizing mortgages originated in 2006 and securitized into ALT-A MBS by LTV, FICO, and occupancy rate shows that the cumulative losses to date for this profile as of the first quarter of 2014 have been 2.9%, with 16.7% of the original unpaid principal balance remaining. There are many ways to estimate the expected losses for the remaining 16.7% of balances that leave room for subjective interpretation and analysis, but clearly this conservatively benchmarked profile from the 2006 vintage won't get very close to breaking the 7.3% AAA support level assigned to the recently issued MBS. Investors who think a repeat of 2006 loan performance is anything other than extremely remote may also want to take a closer look at changes to lending practices in mortgage originations over the past seven years.

In 2006, the research and methodologies behind the credit-rating agency models were as opaque as the market values embedded in the financial statements of those issuing private MBS at the time. Today, the assumptions behind the models are clearly defined and readily available, as are the historical data to support the statistical output of the models developed. Although AAA will always be a somewhat subjective measure, investors should feel more secure than they did in 2006. Despite all the improvements, liquidity for new-issue private MBS is sparse at best. The market has become thinly traded and illiquid. An issuer of MBS in 2006 could easily pick up the phone and get reliable pricing guidance on where a generic private AAA MBS would trade, but the range of expected yield spreads today can swing by over 1% from one call to the next. This lack of liquidity is driven by a lack of investor trust in the ratings, which is hardly surprising, given the daily headlines about mortgage fraud, lawsuits, and allegations of collusion.

In addition to the clearly more conservative credit enhancements, many other changes in the mortgage-origination business could give investors a greater sense of security in mortgage credit, but these improvements get far less coverage in the media than the issues that brought about those changes. Every day, we are bombarded by media coverage of mortgage fraud, appraisal fraud, and collusion. Where are the articles detailing all of the steps that have been taken to reduce these risks? By now, anyone who reads the newspaper knows that appraisal fraud was prevalent in 2006, but do they know that regulatory changes make appraisal fraud in the mortgage space nearly impossible? Do we see more articles regarding the fraud associated with "liar loans" and the devastating results for MBS investors or the fact that Ability-to-Repay rules and regulations have removed "liar loans" from the spectrum of assets eligible for private MBS (consequently, newly issued MBS require 100% full documentation of income)?

None of this is to say that newly issued AAA private MBS are entirely risk free, but the circumstances that will result in a loss of principal to the holders of new-issue AAA MBS are far more extreme than they were in the past. The regulatory constraints in the residential mortgage industry make it illegal to replicate the lending practices that inflated the housing bubble on the backs of borrowers that could not afford the loans they were given. Distorted coverage perpetuating fear and mistrust that culminated from an environment that no longer exists does a disservice to the investment community and global economy.

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