

PPIP: Investors can do better

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Are the Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program (PPIP) still needed?

Initiated during the peak of the credit crisis last year, these programs had two objectives: First, stop the panic in the financial markets. Second, help banks, in particular, by improving liquidity and ensuring that the leverage unwind occurs in an orderly fashion. Fraught with panic, investors were afraid to buy new securities when prices of the previous securities were spiraling downward. TALF was intended to support newly issued, AAA-rated asset-backed securities (ABS) to boost consumer credit, while the PPIP was designed to help banks sell underperforming loans and securities by giving incentives to private investors. The programs provided financing to make way for new investors to enter the market and increase their confidence.

We believe the markets are again working as they should. Since its inception, TALF investors ranged from a high of 78 percent of monthly ABS issuance to a low of 44 percent in July, so private funding is returning to the market. Clearly, the panic is gone. The programs now serve mainly to improve the balance sheets of banks as they work through their huge inventories of bad loans.

Whether necessary or not, can investors benefit from the government programs?

The PPIP was initiated to help banks. Investors can benefit, too, but they should remember that the creation of an effective investment strategy that enhances returns was not the government's primary objective. The program is intended to entice investors to buy the troubled assets that banks invested in during the peak of the lending frenzy—securities backed by loans that are now deeply underwater and have very high rates of delinquency.

These are generally the riskiest securities that are trading at low dollar price levels. Under the PPIP guidelines, fund managers have greater incentives to purchase those riskier, lower-priced securities, because they have the potential to generate higher returns on investment than higher-priced securities. Low dollar priced option ARMs—among the biggest problems for Bear Stearns, Washington Mutual and Countrywide Financial before their demise—are an example of the investments encouraged by the PPIP guidelines.

At Advantus, we don't believe such a potentially concentrated strategy in such risky securities is the best investment approach. There are other sectors of the mortgage- and asset-backed securities markets that are supported by far safer loans, have better risk-return characteristics and provide diversification across the mortgage market. We discuss this in more detail below.

What are the other distressed asset classes that the PPIP managers may be missing?

A number of distressed opportunities exist outside of the focus of the government's investment programs. In the non-agency residential mortgage-backed securities (RMBS) sector, we like very seasoned subordinated securities backed by both 15- and 30-year loans. These securities offer substantial carry, trade at deep discounts to par offering the potential for future price appreciation and insulate investors from much of the home price depreciation experienced over the past three years. Additionally, in the consumer ABS sector, seasoned auto subordinated securities provide compelling total return opportunities, also offering strong carry and the potential for price appreciation as deal de-levering invites rating agency upgrades. Within the commercial mortgage-backed securities (CMBS)

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sector, by underwriting individual loans in securities investors can find attractive high return securities and avoid the weak, over-levered loans originated in bubble years. Even higher premium non-agency RMBS, while not necessarily in the sights of the PPIP manager, typically offer compelling carry opportunities. At Advantus, we've managed our High Yield Mortgage Securities Strategy with broader diversification than would be encouraged by the government programs, focusing on the most attractive investments available through the credit cycle.

Is the leverage that is touted as being so important for the PPIP really needed to get attractive returns?

Typically, distressed securities strategies do not employ leverage because they already assume a high return and volatility profile without borrowing to create more. The leverage is being provided by the Treasury to inflate asset prices in an effort to prompt the current holders of those distressed investments (banks) to sell them at higher prices, lessening the risk to banks' balance sheets.

Everything else being equal, when leverage is added your investment is at greater risk. In the PPIP, the risk of added leverage comes in the form of Asset Coverage Tests; if the value of your portfolio falls to a certain level, then cash flow goes to repay the government loans, not to your bottom line, extending the time before you see excess returns. With unlevered yields of 10-15 percent available, we believe attractive diversified returns can be achieved in the distressed mortgage sector without the use of leverage.

Have there been problems for investors dealing with the government's rules for the PPIP or other government programs?

While seemingly generous at the outset, the government's partnership comes with strings attached. Investors must keep an eye on the government's involvement and how it can impact investment decisions. Government stimulus programs initiated over the past year, including the

PPIP, have frustrated investors due to ever-changing rules that are often based on political objectives and not investment goals. Unclear rules regarding executive compensation kept many investment managers from pursuing PPIP mandates. We fear the ever-changing scope of these investment programs and potential changes in the political climate and in administrators managing the program puts investors at risk. Almost every program the Treasury rolled out in the past year has had significant changes after introduction. For example, the Troubled Asset Relief Program's original purpose of buying "troubled assets" from banks and the PPIP for Legacy Loans goal of buying essentially the same loans were either dramatically changed or eliminated. Even a relatively successful program such as TALF 1.0 had several changes after the comment period passed, and after final details were believed to have been finalized. It is likely there could be similar changes throughout the PPIP that materially influence an investor's return, liquidity and other factors.

Why is Advantus a better alternative?

Advantus has been investing in the mortgage securities markets for more than 20 years with cumulative staff experience of 141 years. Our investment professionals have worked on the investing side of the business as well as the lending side, giving Advantus depth of experience in assessing both security structures as well as the quality of loans backing securities. Both of these capabilities are critical to investing in this arena, as is our reliance on fundamental security analysis and security selection. We have developed proprietary underwriting and securities analysis systems that allow for in-depth analysis of securities down to the loan level. Our diversified strategy offers investors a broad selection of sectors and securities, including non-agency RMBS, CMBS and ABS, without the need to employ leverage.

This is intended to provide information to institutional investors and their consultants and should not be considered as a recommendation or as investment advice.