Mortgage security silver linings:

How market inefficiencies are creating high yielding mortgage opportunities

Dean M. Di Bias
High Yield Portfolio Manager

Sean M. O'Connell
Vice President, Director of Research

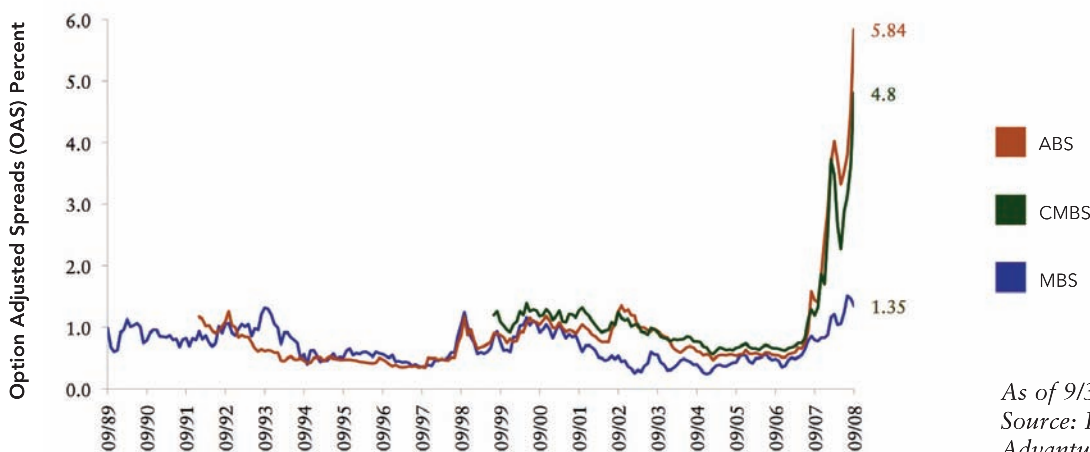
Chris Sebald
Executive Vice President, CIO

For investors with a sharp eye and steady nerves, we believe value is waiting to be discovered in the non-agency mortgage and asset-backed securities markets. As a consequence of rapidly declining home prices, rising mortgage delinquencies, foreclosures, and ratings downgrades, a growing number of sellers have pushed prices down and substantially increased yields on what were recently considered very high quality and safe investment-grade debt securities. As the residential bear market has flushed out a large number of sellers who can't handle the risk of declining ratings, yields on even high-quality investments have risen significantly—in many cases, reaching levels above traditional high yield corporate bonds.

Leveraged investors, including banks, hedge funds, collateralized debt obligation (CDO) managers and foreign investors who drove debt issuance to unprecedented levels in the securitization market, are now out of the picture. As a consequence, yields for structured finance securities have risen significantly to compete with other, higher return, alternative-type investments. Continued balance sheet pressure on financial institutions in the face of a deteriorating economic environment will likely add to current pricing pressures, keeping yield spreads at more than double historical levels.

These opportunities are likely to persist as long as the economy and the real estate markets struggle.

Yield Spreads vs. Treasuries



As of 9/30/08
Source: Lehman and Advantus Capital Management

A brief look back

While the story of the mortgage market's fall from grace has been told many times over, a quick recap gives perspective on how and why we believe incredible values can be found in the market today. Our story opens in the first half of this decade, when the residential housing market in the U.S. attracted massive investment based on the widespread belief that residential housing prices would not fall on a national basis. Debt levels expanded substantially and in hindsight created an asset bubble primarily based in housing.

Massive worldwide liquidity, evidenced by low real interest rates globally, resulted in cheap financing for the U.S. mortgage market as well as for consumer loans, leveraged buyout financing and commercial real estate loans. As this money became increasingly available to the housing market, home prices began to rise in most major markets. Appreciating home prices gave comfort to the lenders whose existing loans were now better collateralized, and they devoted even more capital to this sector.

Explosive Growth
Residential MBS Issuance

Date	Total MBS ($ millions)	Non-agency	
		($ millions)	% of total
1995	318,058	48,891	15.4
1996	440,541	70,046	15.9
1997	487,016	119,319	24.5
1998	929,163	203,487	21.9
1999	832,977	148,270	17.8
2000	614,970	135,908	22.1
2001	1,354,819	266,899	19.7
2002	1,858,381	414,419	22.3
2003	2,718,170	587,125	21.6
2004	1,882,836	864,222	45.9
2005	2,156,007	1,192,272	55.3
2006	2,070,089	1,144,759	55.3
2007	1,878,585*	706,348	37.6

**Estimate*
Source: Inside MBS & ABS and UBS

Soon, affordability became a problem in markets where prices rose the fastest, particularly on the coasts and Sunbelt cities where significant migration was expected. Mortgage lenders offered new, easier-to-get loans with limited requirements for approval. Lenders became emboldened by their confidence that always-strong home prices would bail out their loans should borrowers default. New products such as option ARMs, piggy-back seconds, no-documentation loans and others were created and pooled into securities, most of which were rated investment grade by the rating agencies. The good times ended when more than 10 years of home price appreciation came to a halt in late 2006. Newly created loans began exhibiting striking default trends.

The first sector to crack in the spring of 2007 was the subprime residential market. As prices began to deteriorate, demand for all securitized products began to evaporate. Banks and other dealers, who made large sums of money while the securitization system was working, were caught holding billions of dollars of loans and securities plummeting in value. Liquidity left the market overnight. Many investors used borrowed money to buy these securities and falling prices required them to deleverage their investments rapidly. Banks, reeling from huge losses of their own, began to restrict credit to the leveraged investor community. As more buyers left the market, prices continued to fall. In a short period of time, the market was not functioning.

Guilt by association

Just as most mortgage securities rose in value when real estate values appreciated, in the environment of falling real estate prices all non-agency mortgage-related securities became "guilty by association" and are now treated with significant skepticism. This environment continues today. For example, securities backed by mortgage loans that were originated five or more years ago have fallen significantly in value, even though the homes backing the loans are likely to be worth much more than what the borrowers originally paid for them. While many securities backed by recently issued risky mortgage loans certainly deserve very high yields and junk ratings, yields in nearly every segment of the mortgage market are trading at all-time highs, and much of what is available in the market can be considered extremely cheap investment-grade bonds.

continued

A typical example is a seasoned BBB-rated subordinated security issued by a well-known issuer. It exhibits excellent fundamentals and credit metrics, yet trades at a yield higher than B-rated corporate bonds.

Let's look at the specifics. In the entire pool of mortgages that back this security, there are no delinquent loans and there has never been a loss on any loans that have gone 60 or more days delinquent in the past. The borrowers in the pool have consistently made their mortgage payments for more than five years and they have significant equity positions in their houses. The weighted average loan-to-value ratio is 58 percent, which is considerably lower than the industry average. Because of the exemplary underlying mortgage loan performance, these and similar securities have maintained stable investment-grade ratings, even in an environment where tens of thousands of downgrades have occurred on other mortgage securities. Securities such as these yield between 10 and 15 percent, representing extremely attractive and, we believe, safe investments.

Buying the best structure in a poor performing pool

Seasoned loan pools aren't the only opportunity; we believe attractive and safe investments can also be found in subprime securities under stress. The key to success in this potentially hazardous territory, in addition to careful evaluation of the mortgage loan collateral, is buying the right part of the security's capital structure.

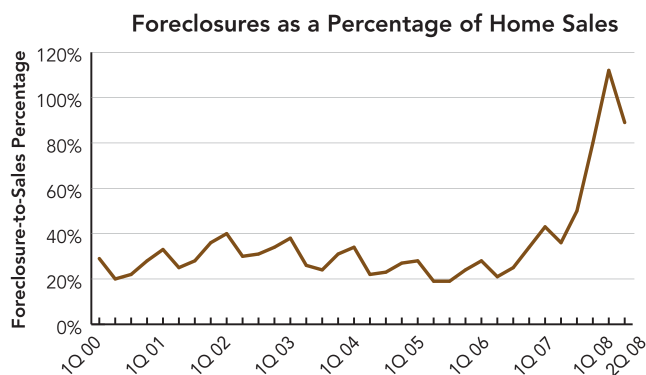
An example in this sector is an AAA-rated, mortgage-related asset-backed security yielding between 10 and 13 percent, approximately twice its historical yield. In this case, the performance of the mortgage loan pool backing the security does not look good. About 39 percent of the loan pool has a balance that is 60 or more days delinquent. The weighted average loan-to-value ratio for the pool is 85 percent, higher than the industry average. In contrast to the previous example, which had more than five years of payment experience and no defaulted loans, the underlying borrowers in this subprime mortgage pool have only 19 months of payment history. Pool losses have already amounted to 1.9 percent of the original pool balance.

The mortgage loans in this example don't provide the basis for investment. But, because of where we can invest in the security's structure (senior vs. junior and early maturity vs. late maturity), these poorly performing mortgage loans actually provide a benefit and have the potential to increase the security's return. The opportunity comes in knowing the capital structure and buying the right segment of that structure. By purchasing the right class of this security, an investor can cash flow out of the bond before the loan losses do harm. In an interesting twist, if defaults occur faster than expected on the underlying mortgage loans, the return for this security actually rises. That's because defaults result in faster prepayments and earlier return of principal. For a security that is purchased at a significant discount to par, this obviously increases its return.

These examples are not unique. The market is full of similar securities because institutions are forced to sell. Prices reflect a lack of buyers in the market, not the inherent quality of the underlying mortgages or the value of the security positions. We believe these opportunities are very likely to be available for some time to come as the financial system moves through its massive restructuring cycle and adjusts to much lower leverage.

Fleeting opportunities?

Mortgage foreclosures are rapidly rising and will significantly add to the inventory of homes for sale. These homes will have to clear the market before housing can regain solid footing. Foreclosure sales push down the prices more than typical sales.



Source: Bank of America

continued

Additionally, the poor real estate market and severe financial credit crisis have likely caused a U.S. recession of greater magnitude than we have seen in the past 30 years.

This, coupled with rolling real estate recessions that are now apparent through the industrialized world, particularly in the United Kingdom, Spain and Australia, is very likely to keep financing and credit conditions tight throughout the global financial system. In the U.S., pundits frequently refer to the nationwide real estate recession we're experiencing as the worst since the Great Depression. While the complexities of the modern financial system make it difficult to compare the 1920s and 1930s to today, we are expecting the housing market to remain soft for many years to come. Historically, it has taken the U.S. market between five and seven years for housing to reach new highs after a real estate downturn begins.

Given the magnitude of the housing market's current slide and the extremely tight credit conditions, our expectation is that the recovery will take much longer than most currently believe. The weak housing market makes it inevitable that additional ratings downgrades will occur, and those downgrades will trigger institutional selling. Because Wall Street, banks and insurers are providing almost no sponsorship for these investments, high-yielding opportunities should remain robust for quite a while.

While this is certainly a sobering outlook for the housing and real estate markets, in our view it is an environment that is likely to create extremely attractive investment opportunities for the foreseeable future. Many investors continue to be forced to sell securities, and the appetite for increasing investments in this sector are likely to remain tainted by those with the recent memory of heavy losses. We believe new investors in this sector are likely to see historically rare opportunities and extremely attractive returns compared to almost any other unleveraged investment class available.

Waiting in the wings

The best opportunities currently exist in the residential securities markets. We believe the deleveraging that hit the financial markets and residential borrowers will roll into other segments of the consumer and commercial securitized and loan markets. This is based on our view that the credit crunch and the global slowdown will impact nearly every segment of the structured finance market.

We expect the current problems facing the residential mortgage market to play out in other consumer-based asset-backed securities and commercial mortgage-backed securities over the next several years. This will likely bring additional opportunities for investors to buy debt at extremely attractive prices in those sectors.

Consumer receivables

With consumers under stress from falling home prices, excessive debt, soft employment markets and rising food and energy costs, consumer debt delinquencies are likely to rise. Just like homeowners, many auto borrowers are upside-down on their loans, owing more than their cars are worth. As a result, delinquencies will increase, leading to downgrades on securities. Similarly, many overextended credit card borrowers no longer have the luxury of tapping their home equity to pay off large balances. Credit card borrowers will have nowhere else to go. We believe this will result in an increase in bankruptcies and defaults and likely lead to downgrades on credit card securitizations.

Commercial real estate

Commercial real estate is likely to come under pressure for the same reasons as the residential mortgage market. The same lending excesses that characterized the residential market occurred in the commercial mortgage market at the end of the lending cycle. The loans issued in this period were so highly leveraged that borrowers will have trouble meeting higher debt service requirements when the interest-only period expires, causing many to default. While the commercial real estate market is displaying early signs of stress, we anticipate it will take longer for the default cycle to fully play out in this sector.

Maximizing the Opportunity

It takes three qualities to manage high yield mortgage opportunities: experience, patience and expertise in the wide variety of securities and asset classes that will likely be under stress. While attractive investments exist, they need to be constantly pursued. They also need to be carefully researched and thoroughly tested. Even with the most thorough due diligence process,

continued

this strategy will likely experience high volatility as deleveraging occurs. Further financial institution failures are likely to emerge, creating additional, currently unforeseen opportunities.

On a macro scale, the biggest risk for the market is a continued erosion of property values. Housing is already down approximately 10 percent nationwide, and the market has priced in an additional 10 percent future decline. If property values fall an additional 10 percent beyond that, serious economic problems are likely to occur, hurting a variety of investments.

A rosy scenario in which the market instantly heals and high yield opportunities disappear is less likely. The wreckage in the mortgage market set securitization back at least 10 years. Until buyer faith is restored, it's not going to snap back.

We believe the mortgage securities market will continue to have its silver linings for those who know how to spot them.

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

This article contains forward-looking statements based on expectations and assumptions. Actual results could differ materially because of changes to these expectations and assumptions.

ADVANTUS® | CAPITAL MANAGEMENT

400 Robert Street North, St. Paul, MN 55101-2098
www.advantuscapital.com | 1.800.665.6005

©2008 Advantus Capital Management, Inc. All rights reserved.

F66119-3 11-2008

0811036-IM A-4