PGIM FIXED INCOME

Perspectives

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RMBS—After the Flood

Part I: A Second Look at Legacy Assets

In the immediate aftermath of the financial crisis, the promise of unlevered double-digit returns precipitated an influx of crossover investors to the legacy non-agency RMBS sector. Over the past seven years, non-agency RMBS have indeed delivered standout performance, but as spreads have tightened, investors have increasingly questioned whether value remains in this opaque and historically tainted asset class. Our response to this question is an emphatic "yes."

The legacy non-agency RMBS market remains a $650+ billion repository of yield and spread in a fixed income landscape that is increasingly devoid of both. While spreads are tighter than they were in the years following the financial crisis, the risks are commensurately lower as well.

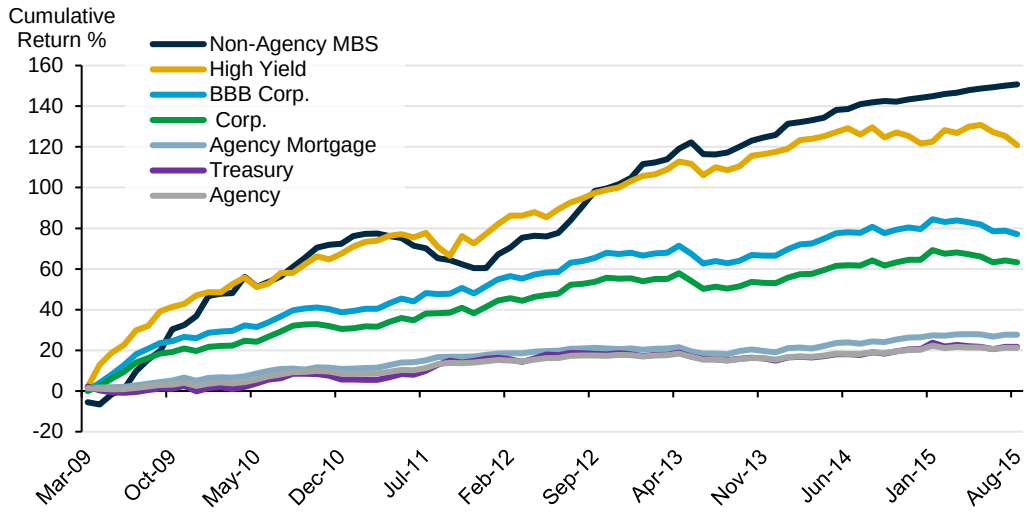
Part I of this series looks at the legacy RMBS asset class. After providing an overview of key post-crisis developments, including policy and regulatory risks, this paper examines the sector's favorable fundamental and technical underpinnings and follows with an update on litigation strategies, where recent developments have been adverse. We conclude by highlighting investments, including re-securitization strategies, that we believe offer superior risk/reward for investors willing to stay the course.

A Post-Crisis Review of Legacy RMBS

As the floodwaters of the financial crisis receded, opportunistic investors waded into the legacy non-agency RMBS sector as security prices plunged in response to the twin challenges of eye-watering fundamentals and relentless market technicals. While non-agency RMBS were perhaps the most dislocated of structured products at that time, similar, albeit less compelling, opportunities also presented themselves in CMBS and, to a lesser extent, in ABS. As markets emerged from the financial crisis, spreads tightened massively across all risk assets, but RMBS stand out as the best performer since the nadir of 2009.

While other markets, notably CLOs and CMBS, have rebounded in recent years and again enjoy a robust primary issuance marketplace, the RMBS market remains a legacy market. This dichotomy is frustrating to some, and perplexing to policy makers who fail to appreciate the depth of investor grievances, yet we believe that investors are well justified in drawing a distinction between RMBS and other asset-backed markets.

THE RESURGENT PERFORMANCE OF LEGACY NON-AGENCY RMBS



Source: Amherst Pierpont Securities, Citigroup as of August 2015

Although a topic for another paper, we believe the tepid reincarnation of the private label RMBS market (RMBS 2.0 as it is sometimes termed) remains fundamentally flawed, as detailed in the accompanying catalogue of risks. Pramerica Fixed Income is an active participant in efforts to address the structural shortcomings of this nascent recovery, but in its current state, the new issue RMBS 2.0 market offers little fundamental value, a host of structural flaws, and unique public policy risks.

While the aforementioned public policy and structural risks also remain an issue for legacy assets, we believe the legacy market can offer investors far better compensation for assuming these risks. Additionally, investors can mitigate the impact of such risks via thoughtful re-securitization strategies, as we detail in the latter part of this paper.

The wave of regulation engendered by the financial crisis has been another challenge for the fixed income markets, but has also created opportunities. In particular, changes to capital and leverage requirements for investment and commercial banks has made the repo financing business less viable, raised the cost of financing, and made leveraged investors wary of the stability and reliability of such leverage. Europe's largest wholesale banks will likely reduce their repo balance sheet by another 10-15% in coming years, according to research from Morgan Stanley and Oliver Wyman, and U.S. banks are likely to pull back as well.[1]

Structural and Policy Risks in RMBS

Distrust of Key Deal Agents:

Trustee *– Remain passive participants with unacknowledged fiduciary responsibilities. Indemnification language remains a sticking point in governing documents.*

Servicer *– Ongoing litigation with Ocwen and other servicers, despite well-documented failures to perform duties adequately, highlights the difficulty in removing servicers, and RMBS 2.0 documents remain unhelpful in this regard.*

Representations and Warrantees (R&W) *– RMBS 2.0 documents have made strides in addressing enforceability shortcomings, but lack of R&W standardization remains an issue and key concepts including the meaning of "material and adverse" remain poorly defined.*

Public policy risks:

- *Ambiguity regarding 1st lien priority versus 2nd lien priority*
- *Regulators' cooption of servicers to achieve public policy agenda including use of trust assets to settle servicer liability (National Mortgage Settlement)*
- *Use of eminent domain to seize collateral from trusts*
- *Consumer Financial Protection Bureau oversight of servicers and originators*
- *Changes to state laws and policies that increase investor losses by making it more difficult for servicers to liquidate seriously delinquent loans. Examples include California Homeowner's Bill of Rights and changes to NY and NJ foreclosure processes.*

[1] *Wholesale and Investment Banking Outlook, van Steenis et al, Morgan Stanley & Oliver Wyman, March 19th, 2015*

THE CONTRACTION IN U.S. AND EUROPEAN BANK BALANCE SHEETS

	Approximate Balance Sheet Changes: 2010-2014	Further Reduction Potential
Rates & Repo	-30%	-15% to -25%
FX, EM, and Commodities	-25%	-5% to 0
Credit and Securitized	-30%	-5% to -15%
Equities	0	-5% to 0
Total`	-20%	-10% to -15%

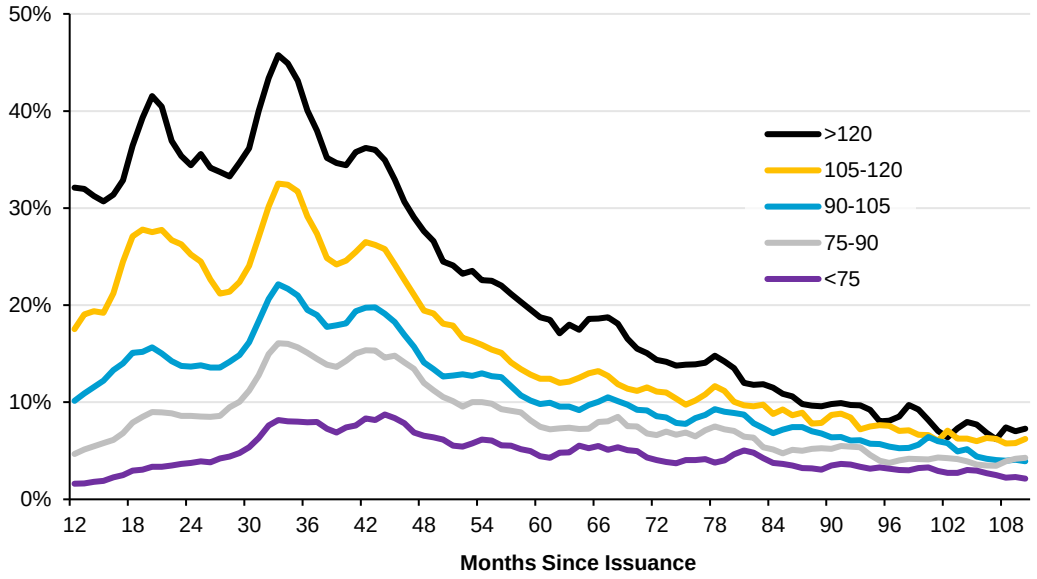
Source: Morgan Stanley, Oliver Wyman Wholesale & Investment Banking Outlook (March 19th, 2015)

This retrenchment, coupled with investors' vivid memories of the crisis-era perils of short-term mark-to-market leverage, has consequently increased the number of market participants seeking term, non-recourse leverage or structures that implicitly offer the same. This financing squeeze has precipitated new opportunities, including what we view as the superior Sharpe ratio trades of single-CUSIP and multi-CUSIP re-securitizations (re-REMICs).

Legacy RMBS: Fundamentals Remain Supportive

One of the key drivers of the rally in non-agency RMBS has been a meaningfully positive turn in their fundamental underpinnings. Of note, U.S. home prices have recovered 34% since the lows of early 2012 after falling 35% from the peak in June 2006. As a result, the percentage of homeowners who remain "underwater" on their mortgages has fallen from a crisis peak in excess of 25% to approximately 10%, and the percentage who owe 20% or more than the value of their homes has fallen from 12% in 2009 to less than 5% today. The 20% hurdle looms large in both popular consciousness and the concomitant public policy risks associated with private label RMBS, due in part to early crisis-era research by the Federal Reserve Bank of Boston noting that "borrowers who have seen the market value of their homes fall by more than 20% since purchase are more than 15 times more likely to lose their homes as compared to people who have seen their property values appreciate by at least 20%."[2] While the aforementioned paper and subsequent research note that "negative equity is a necessary but not a sufficient condition for foreclosure," lingering negative equity remains an obsession for housing advocates and left-of-center policy makers, even as data reveal declining serious delinquencies among borrowers who are deeply out-of-the money.[3]

RATE OF 1ST INCIDENCE OF SERIOUS DELINQUENCY: 2006 ALT-A BY COMBINED LOAN-TO-VALUE (CLTV)



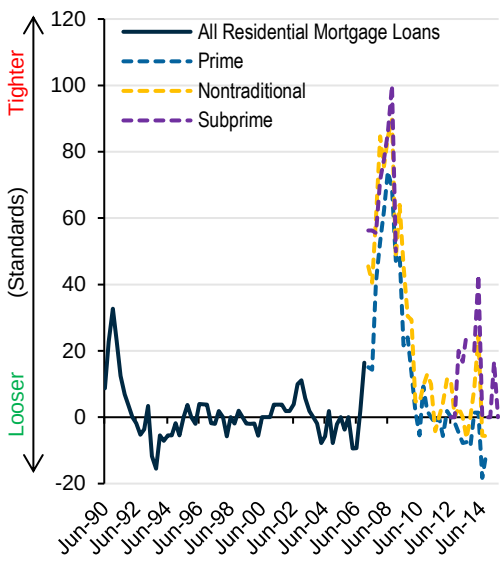
Source: Loan Performance, Pramerica Fixed Income

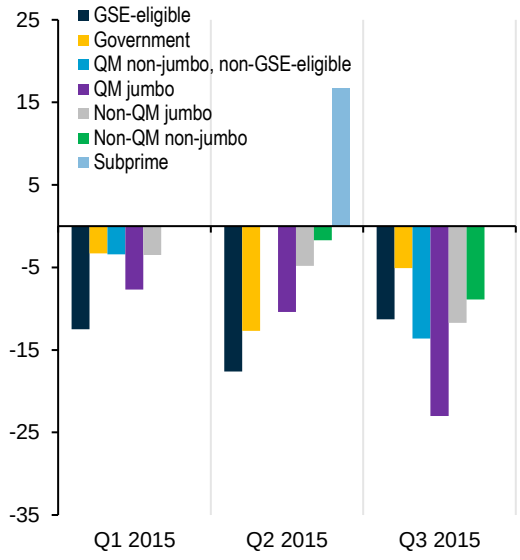
As discussed below, we currently expect further price gains for U.S. housing at both a national and regional level, with the exception of potential oil patch weakness. In particular, we believe the uneven nature of the recovery across price tiers and regions will likely diminish as U.S. economic activity remains comparatively healthy. A key

[2] *Foote, Gerardi, Goette, and Willen, 2008. "Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't", Federal Reserve Bank of Boston Public Policy Discussion Paper 8-02*
[3] *Foote, Gerardi, Willen, 2008. "Negative Equity and Foreclosure: Theory and Evidence", Federal Reserve Bank of Boston Public Policy Discussion Paper 8-03*

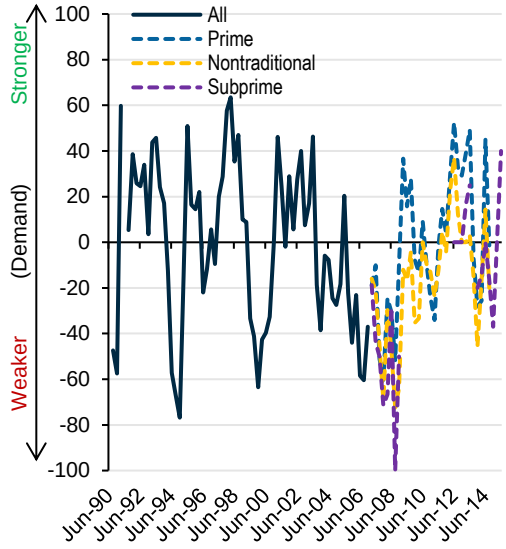
factor in our expectation for broader price gains going forward is improvement in mortgage credit availability. The most commonly cited measure of credit availability is the Federal Reserve Senior Loan Officer Opinion Survey, which shows an ongoing increase in the percentage of loan officers reporting loosening underwriting standards and reporting higher demand for residential loans, as illustrated in the following charts.

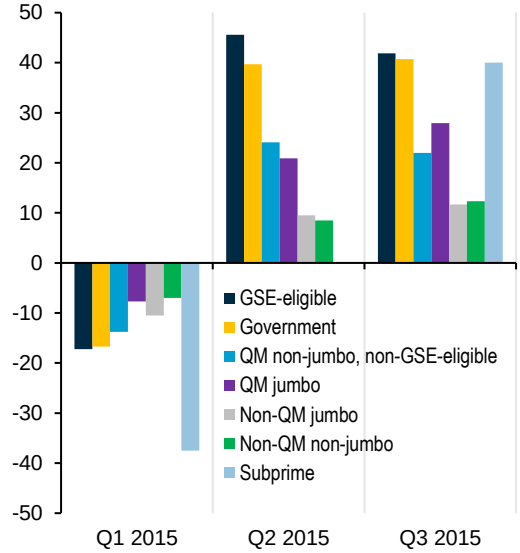
FRB SR LOAN OFFICER SURVEY[4]: THE DOWNTREND REVEALS LOOSENING UNDERWRITING STANDARDS...





...WHILE THE UPTREND INDICATES RISING MORTAGE DEMAND.



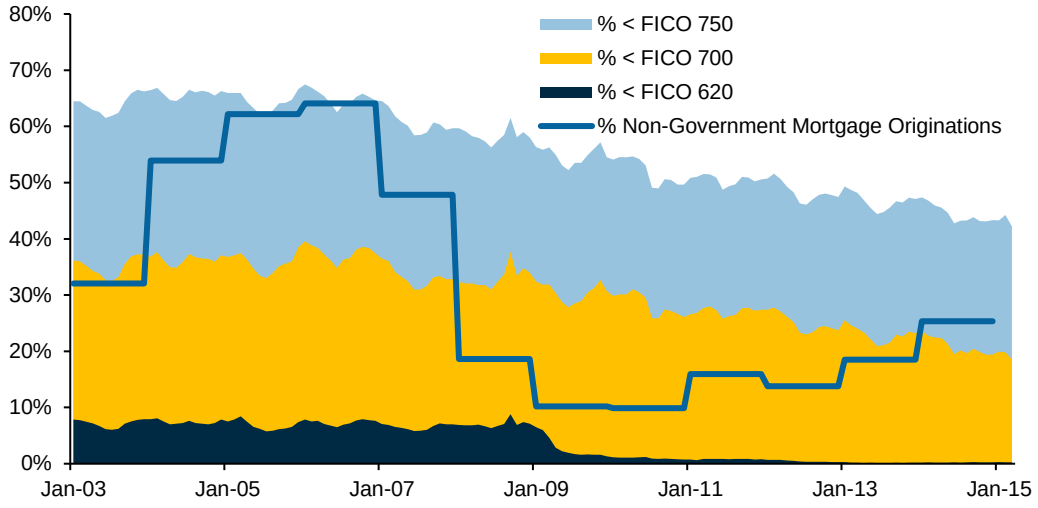


Source: Federal Reserve Board Senior Loan Officer Opinion Survey

While the Fed's Senior Loan Officer Opinion survey shows the direction of underwriting standards, data on mortgage origination by FICO score more clearly illustrate the magnitude of underwriting shifts. From that perspective, one can see that although mortgage credit availability is improving, current standards remain highly stringent, even compared to the relatively prudent 2003 era. When coupled with rebounding demand from borrowers, we view the potential for further expansion of mortgage availability as a potential catalyst for further broad-based gains in home prices.

[4] *Federal Reserve Board Senior Loan Officer Opinion Survey reports the percentage of loan officers reporting tighter/looser underwriting standards and higher/lower borrower demand.*

MORTGAGE ORIGINATIONS BY FICO SCORE



Source: Black Knight Financial Services, Morgan Stanley Research

Another contributor to our continuing housing optimism is the improvement in the supply dynamic. According to U.S. Census data, the monthly supply of houses for sale in the U.S. is currently half of the peak level from 2009 and below the long-term average of 6.1 months. In the near-term, we would not be surprised to see this figure increase modestly as there is likely a backlog of supply from sellers trapped with low or no equity. On the other hand, the supply of homes from foreclosure and real estate owned (REO) is still poised to decline going forward as distressed inventory remains a fraction of its crisis peak and continues to improve.

MONTHS SUPPLY OF HOUSING FOR SALE IN THE UNITED STATES

Source: Federal Reserve Economic Data

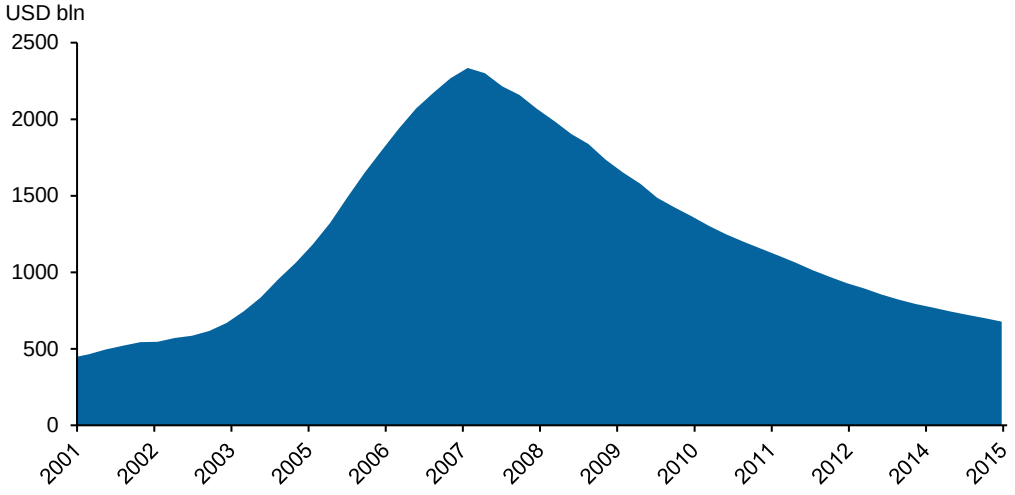
Uniquely Supportive Technicals

Beyond the positive fundamental tailwind of improving economic activity, rising home prices, and diminishing distressed supply, we also view the technical underpinnings for the non-agency RMBS market as being very favorable. From a peak in excess of $2.3 trillion in 2007, the outstanding non-agency RMBS market is roughly $650 billion today and declining at 10% to 15% per year.

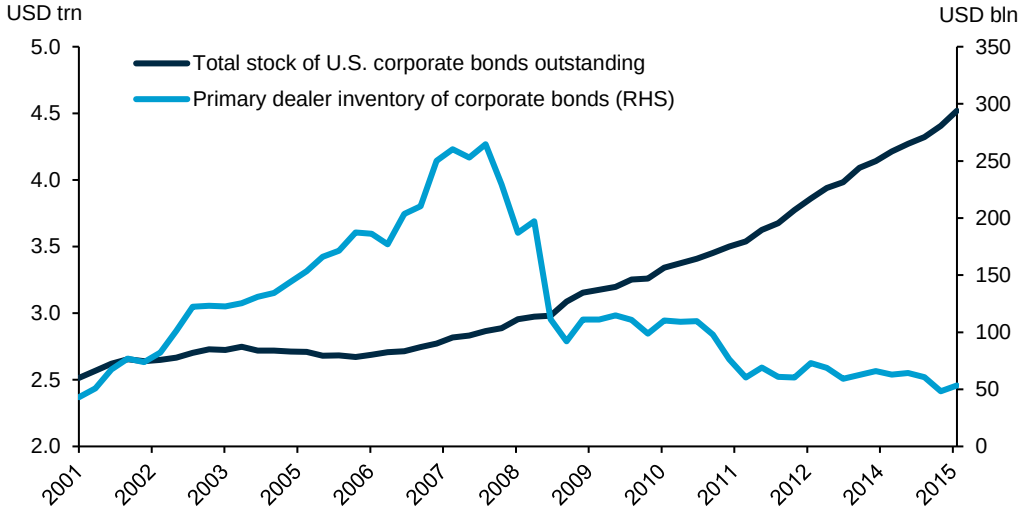
This stands in sharp contrast to the deluge of supply in other spread sectors, notably investment grade corporates, and is a key factor in the diminishing correlation between legacy RMBS and traditional credit sectors. While the decline in private label float has led some participants to express concern as to the long-term viability of these investments, it is worth keeping in mind that at roughly $650 billion, the legacy non-agency RMBS market remains larger than the private label CMBS market. Additionally, TRACE data show that the turnover rate of the non-

agency market has remained remarkably resilient despite the regulatory challenges faced by the broker/dealer industry.

A FAVORABLE TECHNICAL AS OUTSTANDING PRIVATE POOLS/ TRUSTS DECLINE



TECHNICALS IN THE CORPORATE BOND MARKET DIFFER MATERIALLY FROM THOSE IN STRUCTURED PRODUCTS



Source top chart: Federal Reserve. Source bottom chart: Haver Analytics

Litigation Strategies Fade In Importance

Another factor in the RMBS price recovery has been successful litigation against RMBS sponsors for breaches of representations and warranties (R&W). The following table shows significant landmarks in the private litigation actions against securitization sponsors. However, litigation strategies have faded in importance in recent months largely due to two factors. First, several landmark settlements that have either been approved, or are likely to be approved, have reduced the uncertainty regarding the amount and timing of the respective settlements. Secondly, the New York Court of Appeals' upholding of the Appellate Division's ruling in ACE Securities Corp v. DB Structured Products Inc., while wrongly decided in the opinion of many investors, strongly indicates that securities that are not subject to tolling agreements are unlikely to derive any incremental value from R&W putbacks.[5] This clarity has not only reduced the valuation challenge posed by private label securities by eliminating or diminishing the element of probabilistic litigation analysis, but, more importantly, has also repriced bonds that had their prices inflated due to highly speculative litigation assumptions. While important litigation activities continue, namely action against the securitization trustees and servicers (notably Ocwen), we believe recoveries are unlikely to approach the $8.5 billion standard established by the Countrywide/Bank of America settlement.

[5] *Tolling agreements pertain to the expiration of the statute of limitations, and "putbacks" refer to those made to originators and securitizers.*

Landmark Recoveries Pertinent to the RMBS Sector

Deal	Responsible party	Payout/Estimated loss reversal to date	% of past and future losses
SVHE 2006-WF1	Wells Fargo	$83mn cumulative ($55mn of cash payout; $28mn of loan-level putbacks have occurred earlier)	32%
ZUNI 2006-OA1	Countrywide	$40mn of loan repuchases	32%
CWALT 2007-OA10	Countrywide	$36mn of loan repurchases	16%
MLMI 2007-MLN1	BoA/ML	$86mn of loan repurchases	16% for group 2 loans
BSMF 2007-AR2	JPM	$30mn	14% (Including the payout from the JPM settlement)
MSAC 2006-HE3	Either of Decision One, WMC	$16.5mn payout	14% for Decision One loans; or 5% for WMC loans
CMLTI 2006-WF2	Wells Fargo	$28mn of loan repurchases	14%
FGIC wrapped CWHEL deals	Countrywide	$355mn payout to trustees; $584mn payout to FGIC	12% (14% based on past losses and D30+balance)
RAMP 2006-RS3	RFC	$30mn of loan repurchases	12%
SAMI 2007-AR6	JPM	$65mn of loan repurchases	12%
DBALT 2006-OA1	DB	$29mn	11%
DBALT 2007-OA4	DB	$91mn	11%
DBALT 2007-OA3	DB	$53mn	10%
FFML 2006-FFB	BoA/ML	$51mn of loan repurchases	10%
MABS 2007-WMC1	WMC	$52.2mn	12% for Group 2; 2% for Group 1
MABS 2006-HE3	WMC	$13.8mn	9% for WMC loans
FFML 2006-FFA	BoA/ML	$48mn of loan repurchases	8%
STACS 2007-1	SunTrust	$19mn settlement payout	8%
CWALT 2005-62	CW	$28mn of loan repuchases	7%
CMLTI 2006-WF1	Wells Fargo	$13mn of loan repurchases	7%
Gibbs & Bruns settlements	ResCap	$7.3bn liability claim; ~$800mn payout	Payout: 1-2% for RFC; 4.5-6% for GMACM shelves
	Countrywide	$8.5bn	10%
	Citigroup	$1.125bn	7.6%
	JP Morgan	~$4.5bn	7%

Source: Nomura

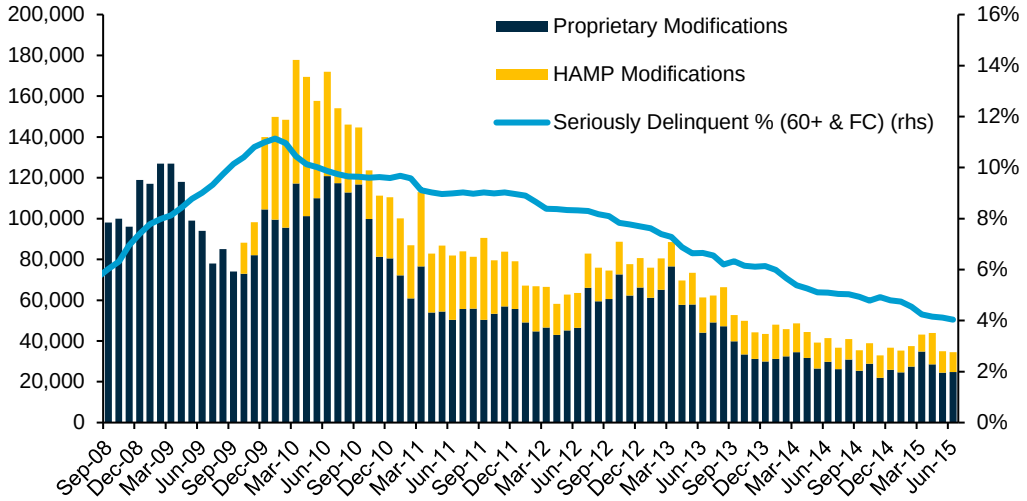
Public Policy Risk Recedes

Also contributing to declining risk in the RMBS sector is the receding spectre of public policy risk. Investor concerns are well justified, having previously found themselves on the short end of a host of policy initiatives by local, state, and federal agencies that benefitted homeowners at investors' expense (refer to page 2 box on RMBS 2.0 for more detail). One of the best examples of policy risk is the push for principal forgiveness modifications by well-intentioned housing advocates. Although principal forgiveness has been a cornerstone of private label modifications under the Home Affordable Modification Program (HAMP) for several years, there is no solid empirical evidence that such modifications are superior to forbearance modifications. In fact, at least one highly regarded servicer has categorically stated that principal forgiveness plans are suboptimal modifications, yet the servicer is obligated to offer them under HAMP. Still more telling is the fact that the Federal Housing Finance Agency (FHFA) has steadfastly concluded, under both Acting Director DeMarco and Director Watt, that principal forgiveness modifications are not in the best interest of conserving the assets of the GSEs.

Despite this dismal track record, policy risks for legacy assets have receded over the past few years. In the first quarter of 2015, the percentage of HAMP modifications declined 19% QOQ, according to U.S. Treasury data. As an earlier exhibit showed, the percentage of borrowers that are materially underwater has diminished substantially since 2010, reducing the justification for further principal forgiveness modifications. Furthermore, the most recent investigation of the servicing industry, led by the New York State Department of Financial Services, appears to be more sensitive to investor interests than past regulatory investigations.[6] Lastly, the U.S. Treasury's efforts to create a new private label benchmark security have focused policymakers' attention on investor distrust of key deal agents and the politicization of investors' contractual rights.

[6] *New York State Department of Financial Services In the Matter of Ocwen Financial Corporation, Ocwen Loan Servicing, LLC.*

TRENDING OF TOTAL COMPLETED LOAN MODIFICATIONS AND % OF LOANS 60+ DAYS DELINQUENT

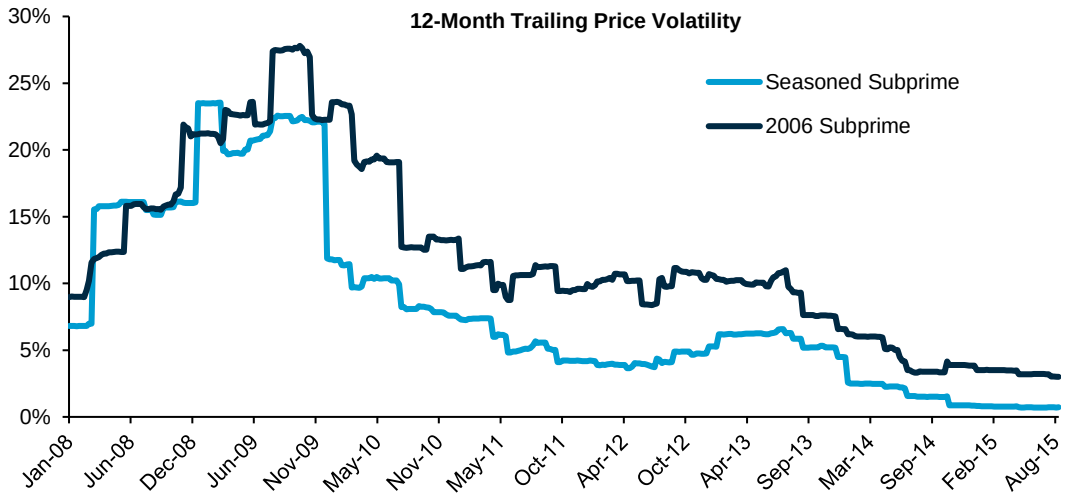


Source: Black Knight Financial Services, www.hopenow.com, Pramerica Fixed Income

Is the Party Over?

A common concern among investors considering additional RMBS investments is the extent to which spreads have already tightened. While legacy RMBS have been one of the best, if not the best, performing asset classes since 2009, they have also been among the most volatile during that time period. Despite this volatility, the high returns generated by legacy RMBS have resulted in a compelling history of ex-post information ratios since the worst of the financial crisis. With volatility for the asset class having diminished dramatically in recent years, we believe ex-post information ratios will remain compelling despite tighter spreads. Importantly, we regard the decline in volatility as secular rather than cyclical, fueled in part by the same factors that caused the rally in asset prices—namely diminishing float and declining valuation challenges associated with more robust data on borrower performance and reduced litigation uncertainty. Moreover, the legacy non-agency RMBS sector benefits from borrowers who are now seasoned eight or more years. These borrowers, having shown a willingness and ability to stay in their homes throughout a severely stressed economic environment, will likely prove to be highly resilient credits throughout future economic and housing cycles.

SUBPRIME PRICE VOLATILITY SETS NEW POST-CRISIS LOWS



Source: Pramerica Fixed Income

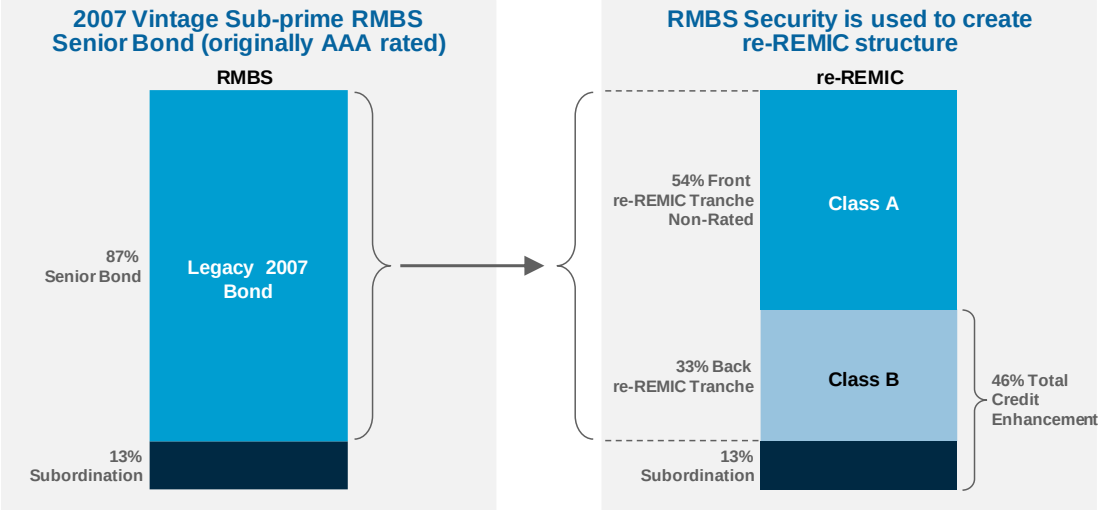
While legacy non-agency RMBS are unlikely to generate double-digit returns going forward, they are likely to generate attractive risk-adjusted returns that are increasingly less correlated to other fixed income investments. We currently see spreads on legacy RMBS assets in the 200 bps to 300 bps range with outliers on either side. Additionally, the increasing shortage of financing for levered participants has afforded investors the opportunity to

create high-quality investments by providing structured financing, rather than owning the assets outright, as we discuss in the following section.

Re-securitization Alternatives to Repo Leverage

One of the by-products of the financial crisis was an avalanche of financial regulation, including restrictions on how banks use their balance sheet (e.g. The Volker Rule, Basel III, Liquidity Coverage Ratio) and the capital charges associated with doing so. As a result, it has become increasingly uneconomic for leveraged participants to obtain financing for private label securities. Additionally, many investors have limitations, either self-imposed or external, with respect to the use of repo leverage. Given these considerations, it is quite common for investors to use re-securitization as a mechanism to lever private label exposures without being subject to the mark-to-market risk of traditional leverage and its associated recourse to other portfolio assets.

THE STRUCTURAL ENHANCEMENT OF THE RE-REMIC STRUCTURE



Source: Pramerica Fixed Income. For illustrative purposes only.

There are several common approaches to conceptualizing re-securitization. One is that Class A (Senior) holders are providing financing on the underlying bond to Class B holders. Another is that Class B represents being long the collateral and short the Class A. With respect to re-securitzations of legacy RMBS, our preferred description is that re-securitization is a mechanism of decomposing a multifaceted investment in the underlying bond into a credit component (Class B) and an illiquidity/complexity component with greatly diminished credit risk (Class A). Not only is this conceptualization helpful in determining the fair economics of a re-securitization, but it is also a helpful discipline in evaluating our purchases of the underlying bonds. In instances where the mezzanine looks attractive from a risk/reward perspective, we generally prefer to own the mezzanine implicitly by owning the underlying bond (i.e. the Class A *and* the Class B). In most cases, however, we find that the demand for term, non-recourse funding is such that the Class A looks like a much better Sharpe ratio proposition than the mezzanine.

From a structuring perspective, there are two considerations of paramount importance—the attachment point (level of enhancement provided by the Class B) and the cashflow prioritization of payments between Class A and Class B. First, with regard to the senior attachment point, our goal in re-securitizations is to create a bond that remains loss remote across a wide array of possible stress scenarios. It is worth pointing out, however, that an ancillary benefit to investors from re-securitizations is the ability to structure exchangeable certificates, or the ability to exchange one note for a combination of other notes. This embeds the capability of restructuring bonds in the future, in response to changing fundamental, regulatory or capital markets dynamics, without the time and expense of another (re)-re-securitization.

The second consideration for investors in re-securitizations is mitigating interest-rate risk. Although many investors in private label securities discuss value in loss-adjusted yield terms, rather than loss-adjusted spread terms, we believe the spread metric is more appropriate. For bonds with fixed-rate structures, the conversion from yield to spread is straight forward. For bonds with floating-rate structures, particularly excess spread/over-collateralization

structures, the traditional use of discount margin masks the significant duration potential on the bonds due to low available funds caps and depleted/non-existent credit enhancement levels. In such cases, we endeavor to create a Class A that is senior with respect to both principal and interest, thereby channeling much of the interest-rate risk, in addition to the credit risk, to the mezzanine.

An additional consideration for investors is whether to invest in rated re-securitizations or non-rated re-securitizations. While both rated and non-rated securitizations are common, in our experience rated re-securitizations frequently entail a greater embedded arbitrage for the securitization sponsor than the non-rated structures. The opportunity for greater securitization arbitrage arises because rated re-securitizations generally trade 25-50 bps tighter than non-rated bonds (depending on the actual rating achieved) even though the senior attachment point is often not materially different for rated versus non-rated re-securitizations. This highlights the fact that ratings remain an important motivation for investors, even as regulators have worked to eliminate the Nationally Recognized Statistical Rating Organizations (NRSROs) from the regulatory construct. While some of the spread differential between rated and non-rated bonds is attributable to the economic costs of a higher attachment point on the Class A, we frequently conclude that much of the spread differential is pure securitization arbitrage accruing to the sponsoring broker/dealer or mezzanine investor. Lastly, it is important to note that purchasers of rated re-securitizations remain vulnerable to the ongoing unpredictability of the rating agency's methodologies, as evidenced by the downgrades of several post-crisis re-securitizations that were originally rated investment grade.

As the table below illustrates, the re-securitization value proposition is material. While the spread of the underlying collateral deteriorates markedly in our stress scenarios, the loss adjusted spread of the Class A senior bond is remarkably stable across economic scenarios.

Example Model Results for Single Asset Re-REMIC: Loss Adjusted Spread to Forward LIBOR

Home Price Scenario	Optimistic	Base	Stagnant	Retrenchment	Housing Recession
Housing path from March 2015	1st Year: +6% 2nd Year: +6% Thereafter: +3%	+3% per year	1st Year: +0% 2nd Year: +0% Thereafter: +3%	1st Year: -5% 2nd Year: -5% Thereafter: +3%	1st Year: -7% 2nd Year: -13% 3rd Year: -7% Thereafter: +3%
Class A re-REMIC Senior (discount margin)	236	222	214	203	169
Class B re-REMIC Mezzanine (DM)	326	241	79	-110	-487
Underlying: legacy 2007 RMBS (DM)	289	234	138	33	-137
Projected Collateral Default	34.7%	38.1%	45.2%	51.6%	58.9%
Collateral Loss Severity given Default	73.8%	75.2%	77.2%	79.4%	85.7%
Net Collateral Loss (% current)	25.6%	28.7%	34.9%	41.0%	50.4%
Princ. Loss % for Class A re-REMIC	0.0%	0.0%	0.0%	0.0%	0.0%
Spread Duration for Class A re-REMIC	3.9	4.1	4.3	4.6	5.6

Relatedly, at higher levels of interest rates, the spread of the Class B mezzanine deteriorates much faster than the spread of the Class A, reflecting the seniority of the Class A interest to the Class B.[7]

LIBOR Sensitivity

	Base Case		Housing Recession	
	FWD L+0	FWD L+200	FWD L+0	FWD L+200
Class A re-REMIC Senior	222	207	169	98
Class B re-REMIC Mezzanine	241	-128	-487	NA
Underlying: legacy 2007 RMBS	234	27	-137	-345

Source: Pramerica Fixed Income

[7] *Structural nuances will influence the degree to which the senior and mezzanine classes respond to higher interest rates. These include the amount of subordination remaining on the underlying collateral, the principal and interest waterfall of the underlying, and the principal and interest waterfall specifications in the re-REMIC private placement memorandum.*

A variation on the re-securitization theme is the multi-CUSIP securitization. Thus far, Lone Star Funds has been the biggest issuer of multi-CUSIP deals under the LSTRZ shelf. While these securitizations share many similarities with the single-CUSIP re-securitizations, there are important distinctions. Most important is the fact that Loan Star Funds retain control of the collateral pool in terms of actively managing the disposition of assets. This creates a risk that investors could be adversely affected if more attractively priced collateral were to be sold out of the pool, potentially leaving the pool undercollateralized at a later point. Safeguards against such an occurrence include limitations on the percentage of the pool that can be sold without calling the deal, the prices at which securities can be sold from the pool, and the distribution of proceeds between senior holders and mezzanine holders. Another important distinction is the clean-up call and associated coupon step-up feature. Most multi-CUSIP deals are callable at par after one year. While the call feature increases the option cost for investors, this cost is significantly mitigated for senior investors as the Class A senior bond is typically issued at a discount and includes a coupon step-up if the trust is not called after two years. Moreover, if the trust is not called after five years, a mandatory auction of the underlying securities is conducted in order to retire the outstanding bonds.

Importantly, while the prospect of multi-CUSIP securitization evokes the scourge of ABS CDOs, our assessment of multi-CUSIP deals is driven by advance rates on the collateral and other tangible structural features, not model-based abstractions such as less than perfect correlation on the underlying securities. We believe at current spreads of LIBOR plus 300 bps the senior bonds provide an attractive opportunity for investors with the resources to navigate the structural nuances and analyze each underlying security.

Conclusion

- *While the legacy non-agency RMBS market generates less focus from hedge funds and private equity than it did at the height of the crisis, we believe investors are remiss in prematurely overlooking this $650 billion asset class, particularly in light of the tepid yields and poor technicals found in other fixed income sectors.*
- *Although the potential for double-digit returns are diminished, we see spreads for senior bonds generally trading in the 200-300 bps range on a loss-adjusted basis.*
- *Fundamentals have vastly improved due to a robust housing market recovery. We believe strengthening in the real economy and widening credit availability will continue to support the improving collateral performance of legacy RMBS pools.*
- *Technicals are overwhelmingly favorable as the outstanding supply of legacy non-agency RMBS diminishes 10-15% per year.*
- *While RMBS spreads are tighter than they have been in recent history, the volatility of the asset class has declined in sympathy with vastly improved fundamentals and continued strong technicals. We believe this will result in attractive ex-post information ratios and returns that are relatively uncorrelated with the broader fixed income market.*
- *Changes to regulatory standards have made repo financing increasingly scarce, even as lower all-in yields make leverage more critical for the hedge fund industry. We believe investors are well compensated for providing term non-recourse financing via single and multi-CUSIP re-securitizations.*

NOTICE

Source(s) of data (unless otherwise noted): Pramerica Fixed Income as of October 2015.

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