PERSPECTIVES

GAINING NEW MBS RISK INSIGHT WITH ESG ANALYSIS

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A new dimension is being added to Breckinridge's analysis of agency mortgage-backed securities (MBS) and is bringing greater insight to environmental risks specific to these bonds.

MBS are bundles of home loans bought from the originating entity and wrapped into a security offering. MBS investors receive periodic payments of both principal and interest that is passed through from the borrowers of the underlying mortgages to the bondholder. Breckinridge believes that the quality and performance of an MBS needs to be assessed based on the underlying mortgage loans in the pool.

Given that, the firm's process incorporates analysis of how natural disasters such as flooding, water stress, heat stress and hurricanes accelerate mortgage prepayment rates, which can improve our insight into MBS risks. A natural disaster can accelerate the principal prepayment of mortgages in the affected area, as victims qualify for mortgage relief. Therefore, natural disasters impact broad prepayment trends, altering the cash flows and therefore impacting investor returns.

MBS REQUIRE SPECIFIC ANALYSIS

Breckinridge invests primarily in agency MBS. Unlike other municipal and corporate bonds, agency MBS have low credit risk thanks to explicit or implicit guarantees from government sponsored entities (GSEs) such as the Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). Prepayment risk is a key risk for agency MBS because it can affect the timing of cash flows from the underlying pool of mortgages.

Examination of non-traditional financial factors in fixed income investment analysis has been a hallmark of Breckinridge's research process since it began integrating ESG analysis nearly a decade ago. Breckinridge believes that looking beyond traditional data and analysis is a critical part of robust research. The addition of a new climate-related dimension in MBS analysis further differentiates in its evaluation of material fundamental and technical financial risk factors when analyzing agency MBS.

METHODOLOGY FOR RISK ANALYSIS

To better understand prepayment risk in MBS, the Breckinridge team analyzed the buyout policies of GSEs as they relate to natural disasters. The team also researched the experiential effect that these events historically had on mortgage prepayment speeds. Breckinridge compared prepayment speeds six to twelve months after the occurrence of a natural disaster in various geographic regions against the national average of prepayment speeds over the same time period. The firm's research isolated the occurrence and effect of natural disaster-related buyouts on prepayment speeds.

Using this data, Breckinridge adjusts the annualized percentage of a mortgage pool expected to be prepaid above and beyond scheduled amortization in a year, also known as the Conditional Prepayment Rates (CPR). Breckinridge's adjustment is based on the exposure to climate-related risk factors based on the geographic composition of the underlying loans, giving Breckinridge additional and critical information to consider in MBS portfolio management.

In its analysis of MBS, Breckinridge assesses and assigns a climate risk score by the geographic composition of the underlying mortgages to generate an overall climate-risk score at the security level. The climate risk score is used to adjust the CPR for each security that Breckinridge evaluates.

Based on its adjusted prepayment data across all MBS that it purchases, Breckinridge believes it can incorporate climate-related factors into its prepayment risk assessment in a more comprehensive and systematic manner than traditional fundamental analysis. Development of additional relevant security selection criteria can help investors better manage MBS risks within their portfolios.