Agency Commercial Mortgage-Back Securities:

What They are and Why are We Investing in Them?

Q&A | August 2023

Agency commercial mortgage-backed securities (agency CMBS or ACMBS) can play an important part in the portfolio construction process for our clients, offering investment diversification and the opportunity for higher yields relative to Treasuries and other government securities. To better understand the potential benefits and risks of ACMBS, we conducted the following Q&A with James Sims, CFA. James is a senior portfolio manager and co-head of PFMAM's Short and Intermediate Fixed Income Portfolio Management Team.

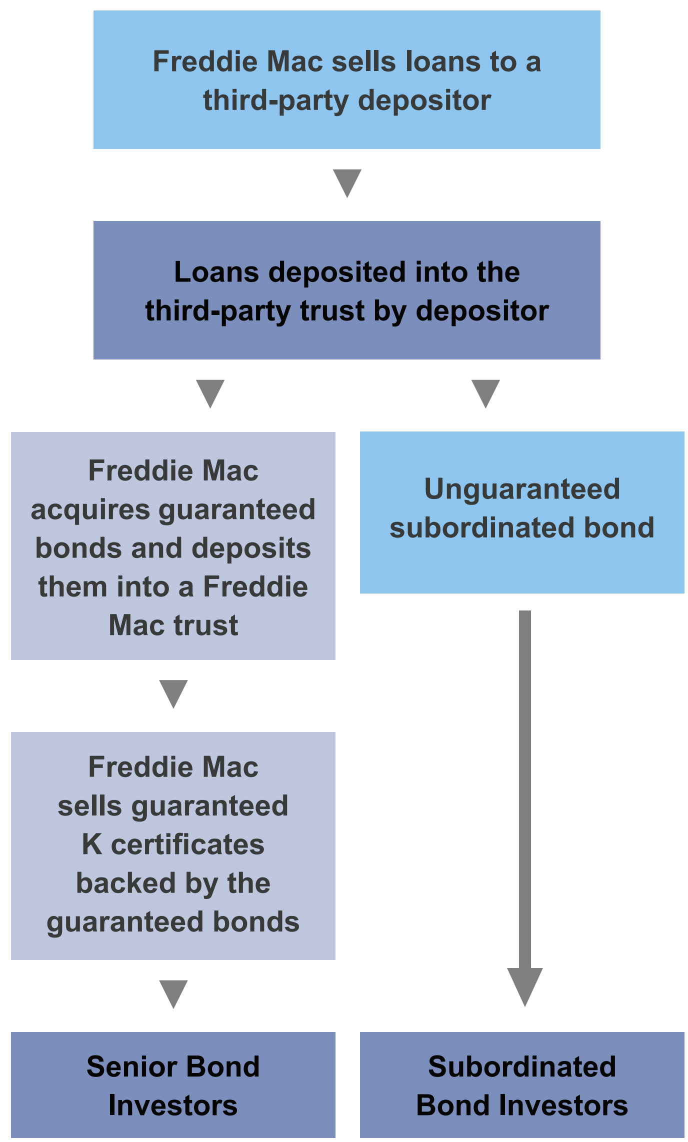
In layman's terms, what are CMBS?

Sims: While the more commonly known type of mortgage-backed securities (MBS) are backed by residential mortgages, CMBS are securities that are backed by underlying commercial real estate loans used to acquire or refinance properties. Similar to asset-backed securities (ABS), these are securitized structures in which the issuer of the CMBS repackages the mortgages into multiple groups of securities (tranches), each with different expected cash flows and risk characteristics. CMBS typically pay interest on a monthly basis.

What are agency CMBS and what makes them unique?

Sims: Agency CMBS are simply CMBS that are structured by a federal agency or government-sponsored enterprise (GSE), like Fannie Mae, Freddie Mac or Ginnie Mae. Critical to their safety, the cashflows of these investments are guaranteed by the issuing governmental entity. (Note: Although most structures have lower-rated, subordinated and/or unguaranteed tranches, *PFMAM only purchases AAA-rated, senior fully-guaranteed tranches*). The agencies have specific programs for ACMBS, like Freddie Mac's "K program."

Let's look at an example. In a Freddie Mac K-Deal, a pool of eligible commercial mortgages is acquired by Freddie Mac and then sold to a third party to be deposited into a trust. The third-party trust then splits these loans into two portions, one of which Freddie Mac uses to create the AAA-rated, senior fully-guaranteed tranches. These tranches are then sold to investors, and cash flows are paid from these loans, with Freddie Mac making up any shortfalls. Agency CMBS allow investors to access the commercial real estate market while mitigating default risk.



What types of loans are securitized in a typical agency CMBS transaction?

Sims: Typically, ACMBS transactions consist of multi-family mortgages, which are loans made to developers of apartment complexes and similar multi-unit housing structures. Other types of loans in an ACMBS transaction may include seniors housing, student housing, affordable housing, and other types of housing with five or more individual units.

What is the difference between an agency CMBS and non-agency CMBS?

Sims: As previously mentioned, ACMBS are issued and guaranteed by federal agencies such as Freddie Mac and Fannie Mae, institutions that are focused on the housing market in some capacity. Because these issuers guarantee ACMBS, the credit risk of the structure is not to the underlying borrowers but to the issuing agency itself. So, if an individual borrower on an underlying mortgage should default, Freddie Mac, for instance, still guarantees the security of cash flows.

To contrast, non-agency CMBS (sometimes referred to as “private-label CMBS”) are not guaranteed by an agency or instrumentality and so they have direct borrower credit risk. These securities are dependent upon the individual borrowers repaying their mortgages, which means there is more credit risk as there is not a separate issuer backstopping the loans. Private-label CMBS are also used to securitize higher-risk loans on office buildings or retail complexes.

This is particularly important in today’s environment as weakness in the office and retail market has become an important topic of discussion. Rising vacancies and delinquencies in office complexes due to workers shifting to a hybrid, work-from-home schedule may impact cash flows for private-label CMBS. That default risk, mitigated in Agency CMBS, is ultimately borne by the investors of private-label CMBS.

What are some of the key similarities and differences between residential and commercial non-residential mortgages?

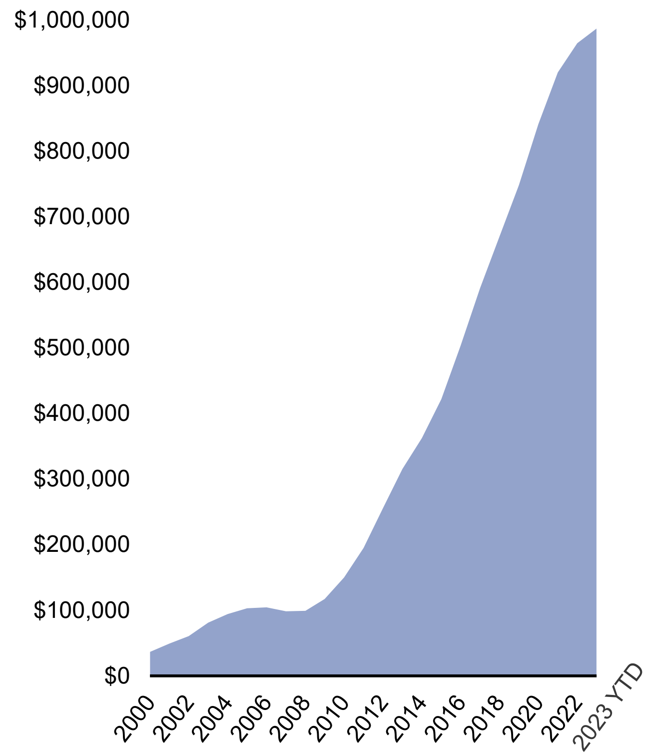
Sims: Residential mortgages are most commonly issued as fully amortizing, fixed-rate loans with 15- or 30-year repayment windows, although floating-rate loans and loans with longer repayment windows also exist. Residential mortgages typically allow borrowers to make early prepayments on the loan, in whole or in part.

On the other hand, commercial mortgages are typically 10 years in length but can have maturities ranging from five to 40 years. While most loans are fixed rate, some can have a floating or variable rate. Additionally, optional early prepayment of these loans is less common due to prepayment penalties which offer investors extra protection. Examples of prepayment penalties may include yield maintenance, lock-out features, prepayment premiums, and defeasances. As a result, ACMBS tend to have relatively predictable cash flows with limited prepayment risk for investors.

How big is the ACMBS market?

Sims: Growth in the ACMBS market has been impressive over the last couple of decades, reaching record issuance levels in 2021. In fact, the amount of outstanding ACMBS is approximately three times what it was just a decade ago. In 2013, these securities began to be included in popular fixed income indices (such as the Bloomberg U.S. Aggregate Bond Index), which helped to increase visibility and liquidity. As of June 30, 2023, the total outstanding amount of ACMBS approached $1 trillion.

Agency CMBS Outstanding (millions)



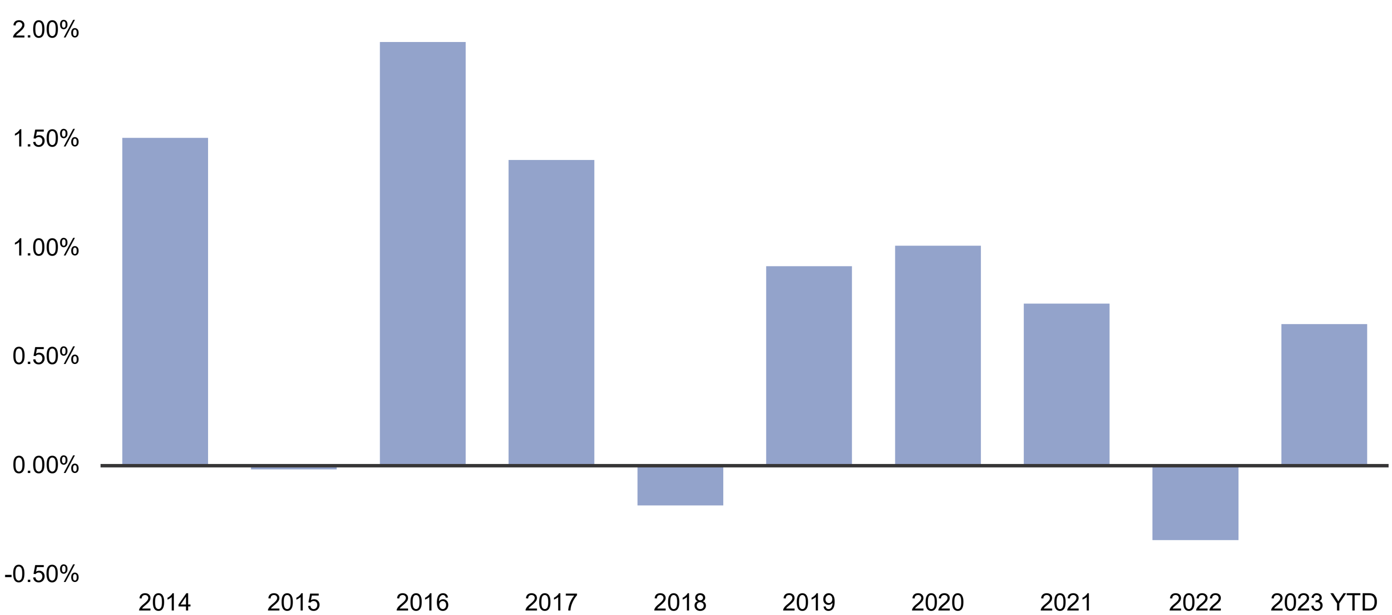
Source: BofA Global Research, as of June 30, 2023.

What are the potential benefits from ACMBS?

Sims: ACMBS is an asset class that offers a high degree of safety due to the agency guarantee, while potentially providing returns in excess of other governmental securities, such as Treasuries.

Since June 2013, the ICE BofA U.S. Fixed Rate Agency CMBS Index has produced excess returns (the additional return vs. a comparable duration Treasury) of approximately 90 bps (0.90%) per year (as shown below). Like all asset classes, valuations can vary depending on the prevailing market environment. Agency CBMS have performed well so far this year.

Agency CMBS Excess Returns



Source: Bloomberg, ICE BofA indices, as of June 30, 2023.

What is PFMAM's approach to ACMBS?

Sims: We conduct a rigorous pre-purchase review of all ACMBS under consideration, focusing on the structure of the transaction and the make-up of the underlying mortgages. When evaluating ACMBS, we take into consideration loan count, property type, loan diversification, geographic diversification, loan-to-value ratios and other factors. In addition, we analyze the prepayment protections to determine the relative stability of cash flows and appropriateness for our clients.

After we purchase an ACMBS issue, we monitor the security to help ensure its performance meets expectations, conducting monthly surveillance on all ACMBS owned in our clients' portfolios. Our focus is on securities that offer the combination of features desired by our clients: agency guarantee, high-quality credit profile, predictable cash flows and relative value versus other fixed income sectors.

Why is PFMAM investing in ACMBS now?

Sims: We consider ACMBS secure and profitable additions to fixed income portfolios and have been investing in the sector for years. The relative stability of cash flows is greater than what is observed in the residential real estate markets due to prepayment protection. This is particularly important during periods of high volatility in interest rates, like what was experienced in 2022-23. There has also been impressive growth in the overall size of the market, increasing both liquidity in the sector and the importance of ACMBS as an investment alternative. Even with some headlines around weakness in certain commercial real estate segments, Agency CMBS remains a well-performing asset class in high-quality, investment-grade fixed income.

In short, owning ACMBS provides another investment option for high-quality portfolios, allowing PFMAM an opportunity to help enhance returns and diversify portfolios for our clients.

For additional information regarding this discussion, please reach out to your PFM Asset Management relationship manager.

To learn more or discuss in greater detail, please contact us:

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