Overcoming mortgage-backed insecurities

Invista Capital Management's Martin Schafer avoids blowups in mortgage-backeds by sticking to basics.

Money manager Martin Schafer understands mortgage securities almost literally from the inside out. During a 17-year career at Principal Financial Group, he initiated or supervised the origination of $350 million of mortgages, as a loan officer, assistant manager of the insurance giant's midwestern home-loan program and as a senior loan associate.

By 1983 Schafer's team was producing more mortgages than Principal wanted to hold. So he began packaging the excess for the Government National Mortgage Association, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp. and selling them into the then-nascent secondary mortgage-backed-securities market.

Schafer's singular perspective on the mortgage business may be one reason the $3.2 billion of pass-throughs that he now manages for Principal's Invista Capital Management has performed so well. In the five years through last December, he showed an average annual gain of 11.3 percent — pretty solid given that Schafer must remain fully invested in mortgages at all times. He discussed his strategy with Senior Editor Alyssa A. Lappen.

Institutional Investor: How did you survive in the first quarter while so many others fell on their faces?

Schafer: Straight pass-throughs are my game, and I'm not making interest rate bets. How life treats me, it treats me. I only have a duration of five to six years, and rates went up in the first quarter, so I lost 4.3 percent. Some of my competitors have hit what I call the absorption barrier. For small extra gains they make big bets. In good markets they draw in money. But David Askin-for-mercy [of Askin Capital Management] goes from $600 million to zero. He's no longer around to get the extra returns in the future. I call it the greatest quarter I've ever had because I lost at least 10 to 20 percent of my competitors.

If you don't make interest rate bets, what is your strategy?

Mortgage-backed securities are very complicated instruments that have the properties of fixed-income paying securities as well as an option written against the investor. So I act like a landlord who will collect mortgage rents from thousands of homeowners across the country and who doesn't know how much those rents will be. I hold multiple coupons in multiple maturities. And I hold them in three buckets. If rates rise, I have one bucket that does okay, one that does very well and one that does poorly. This works the same for low- or flat-rate environments. I have a disciplined approach. If rates rise, I'll lose, and if rates fall, I'll make money, but I will make or lose commensurate with the risks.

How do you avoid the traps?

Your question almost implies to me that I *have* to do some kind of prediction of the interest rate environment and the prepayment rate. These things I do not know. What I do know is that in mortgages, investors have a bad contract. In corporate bonds, as rates rise, duration shortens, and as rates fall, duration lengthens. But in mortgages, if rates rise, duration lengthens, and if rates fall, duration shortens because the homeowner can call his mortgage when rates drop and refinance at a lower cost.

Other mortgage managers go to

Martin Schafer: A singles hitter

Title: Vice president, Invista Capital Management, a wholly owned subsidiary of Principal Financial Group

Assets under management: $3.2 billion in mortgage pass-throughs, including $263 million for Princor Government Securities Income Fund, a mutual fund

Performance (average annual compound return as of 12/31/93): 5 years, 11.26 percent; 3 years, 10.62 percent

great lengths to estimate interest rates and prepayments to figure out what those mortgage options are worth. Don't you use modeling?

Models are only a piece of the puzzle. An option model gives you a snapshot of duration but doesn't tell you what will happen if rates move 300 basis points. It only shows you what's cheap, what's rich and what's the duration if nothing changes. A lot of people wanted option models to be everything, to spit out a number at which you could buy Ginnie 7s. But they don't tell you where that value may be tomorrow, because you don't know where rates are going.

Do you try to push duration out longer when you know rates are falling or shorten up when rates rise?

I try to hold duration to five to six years. But I am willing to readjust. If rates rise, I may have to add to the 9 1/2s [coupon bonds] and sell some of the 6s. I try to do these things: No. 1, dollar-cost-average along with the market; No. 2, stay fully invested. I don't market-time. We invest all our money every day. If rates rise, we add higher-rate coupons. We dollar-cost-average into the higher coupons and out of the low ones.

All I will do for the rest of my career is hit a lot of singles. I'm not going to hit any home runs. But I will not strike out at the World Series. People who second-guess rates will give the farm to me, because they will bet the farm that rates will fall and lose it.

"I'm not going to hit any home runs. But I will not strike out at the World Series."

How do you know when prices are high or low?

There are two ways to value the call option on mortgages, and neither one is the way most of these rocket scientists do it. One is, you assume there are zero prepayments. Recently, we had what I call Ugly Monday [when prices dropped sharply]. We had some 6 percent Ginnie Maes [which fell to a steep discount], and we ran up an analysis that assumed there would be zero prepayments. The worst case [on a discount bond] is zero prepayments. In that case, you have a loan that pays out over 30 years. These bonds were trading at 86 cents on the dollar, and the market was pretty stupid. At that price, these things were paying 35 basis points more than ten-year Treasuries. If someone does prepay, that would be wonderful because they prepay at par.

The other way is to go to the premium side and assume the bonds will prepay instantly. Assume that as the population becomes educated, anytime they can refinance for less, they will. On the premium side I hold stuff at 103 to 105. Anything above that is like playing Russian roulette with five bullets in the barrel. [When premium bonds prepay], returns start to get negative very fast.

Do you track short-term returns?

Short-term performance attracts money. It's sizzle. But [guys who sell it] are modern-day snake oil salesmen. They gather assets and earn a fee. Take options on mortgage funds. In the mid-'80s a lot of funds wrote options on their own mortgage securities. That concept sold billions and handed most investors their heads. Rates fell, mortgages were prepaid, bonds got called, and the funds had to reinvest at lower rates. They got killed on two points. Anything the funds held with an option didn't rise in value because the borrowers got the benefit of their stuff. It was a double call. It was a bad strategy, but it sold.

Why not invest in collateralized mortgage obligations?

On straight pass-throughs — Ginnies, Fannies and Freddies — the market pricing is highly efficient. Prices come in, usually within one quarter of a point of one another. That's very good. It's liquid. In a bad market like the one in late March and early April, even U.S. Treasuries were trading at a bid-asked spread of 5/32, and pass-throughs got up to spreads of 7/32 or 8/32. That is huge. I don't think it gets any worse.

CMOs, on the other hand, are a kind of New Age product. In a good market, where spreads are tight, they're fine. But in a bad market, the bid-asked spreads can move to 10 points. That's 10 percent. Your job as a portfolio manager is to know what will happen to the price the day the market goes south. And the day your market goes south, on D day, the derivatives salesmen are not going to be there. You can't even find Wall Street. No one will give you a quote. And these are on triple-A bonds.

What was Wall Street's role?

Now, Wall Street brokers facilitate the exchange of financial instruments from buyers to sellers. That is a very needed service. But where I start to have problems is with their motive to create products that are extremely confusing so that they can widen their profit margins. These [derivative] products are basically where the sheep — the financial institutions like S&Ls, corporate treasurers, municipal treasurers and insurance companies — are sheared.

I've had brokers in here saying LIBOR is coming down and so I ought to buy inverse floaters. Their motivation is to sell products because they are in the product-creation business. They are wolves. [But] I don't blame them for it. Frankly, the person who bought this stuff is just as much to blame.

Has your previous work helped you manage your portfolio?

This is a hell of a background for a manager of mortgage-backed bonds. I have produced, managed producers, securitized and traded mortgages. And it clearly gives us an edge.

What is your reaction to the first-quarter downturn?

This is great. Our investors got a blue-light special. I can buy bonds at the highest yield in two years.

I've had bad markets before, in 1987. Been there, done that. I didn't lose my shirt. But it was good to have those losses in the first quarter, because a lot of marketing people here needed to wake up to the fact that I was going to have some losses. The market is a great disciplinarian. **it**