Look at the Steep Credit Curve for Good Risk Adjusted Returns

Until recently many fixed income investors had feared of a sharp move higher in rates due to lax monetary policy. A strategy that weighted investments near the short end of the yield curve was a prudent defense. The latest FOMC announcement about “exceptionally low” rates through mid-2013 will require a change in that strategy. Low asset returns are here for the foreseeable future. Considering the shape of the *credit curve*, institutional investors can capture some of the lost return by looking at markets that offer exceptional risk adjusted returns with marginal increases in credit/principal risk. Segments of the residential mortgage market meet these criteria.

Analysis

In residential lending, strict underwriting is the rule of the day. The top ten lenders declined over 28% of residential loan applications in 2010. Legacy issues, over-regulation, and higher capital requirements are the nails in the credit coffin. Many rejected applicants have horrible credit. There are, however, many with sufficient income and assets that can provide excellent risk/return parameters. This condition is likely to persist for years.

It’s interesting to look at what this means in terms of returns. After the big move in rates recently, 30 year fixed government sponsored enterprise (GSE) eligible mortgage loans will be priced below 4% to consumers, the lowest rate in over 50 years. What if you're one of the 28% turned away but can support payments? What are you going to pay and how can investors use this lending trend to their advantage?

Look at the few remaining 'consumer' (old school 'sub-prime') lenders to see to see what borrower’s pay. Anecdotal evidence suggests that fallout borrowers are paying between 9% and 12% for first lien mortgages. These remaining lenders, operating in a few local markets, can dictate terms and rates since the competitive landscape has been wiped clean. Their loans require large down payments, full income verification, and a robust appraisal process. Evidence also suggests that all of these lenders have strong loan demand and could use additional capital.

Institutional capital can enter this market by partnering with one such lender, creating a loan program with risk parameters the investor is comfortable with and realizing steady cash flows from assets protected by high borrower down payments.

Capital markets opportunities exist that could bolster equity returns without introducing liquidity risk. This is a result of the low rate environment and a dearth of structured transactions since 2008.

Compliance and execution risks need careful attention but an experienced and well managed lender should be able to handle those issues. That lender’s ability to service the loans after they close is also important to further reduce any possible cost of a default.

Handled properly with the right lending partner, institutional investors could enjoy very strong risk adjusted returns over the coming years, an environment free from competitive pressures, and the ability to grow and prosper with a needed segment of the non-bank financial services sector.