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Agency vs. non-agency mortgage-backed securities

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Some of the most attractive risk-adjusted returns have really come from investments that focus on the recovering housing market.

Agency mortgages are very high-quality government-guaranteed assets. So, the principal is guaranteed by the U.S. government. It comes in three different forms — Fannie Mae, Freddie Mac, or Ginnie Mae mortgages. They trade at a significantly lower risk premium or spread for the investor because the government guarantees the ultimate repayment of those bonds. Your real risk in agency mortgages is around prepayment risk, or the uncertainty of the timing by which you're going to get your cash flows back.

On the non-agency side, the market is very different. Your exposure there is around the strength and the likelihood of the U.S. consumer to ultimately make good on those payments and make good on the mortgages. So, you have a much more direct exposure to the combination of the strength of the U.S. consumer as it relates to not only their profile, but the underlying strength of the housing market.

Agency mortgages have significantly greater degrees of exposure to interest rate risk. When we think about, you know, what is the risk premium for a given investment vehicle, agency mortgages have a lot more duration, so therefore, are much more sensitive to changes in interest rates. Whereas non-agency securities offer, traditionally, much more attractive risk premiums or overall yield profiles with significantly less sensitivity to changing interest rates.

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