Angel Oak's McBurnette On Opportunities In Housing, Mortgages

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Colin McBurnette, senior portfolio manager at the Angel Oak Funds. Read the Q&A below as Colin says that while high-rate and high-inflationary conditions have made a lot of investors worry about the housing market, those conditions – along with wide spreads and low housing stocks creating an imbalance in the supply-and-demand dynamic – have created real opportunities in the space. The tight market has made the housing market of mortgage credit particularly robust, with strong borrowers as the rate cycle is likely to turn soon; he says the housing and mortgage markets are much more robust now than the corporate credit market in the U.S.

Colin McBurnette

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Colin McBurnette, senior portfolio manager for the Angel Oak Funds is here, we're talking about the housing market and more now on The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and

creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're looking in the direction of the housing market and the securitized loan market with Colin McBurnette, senior portfolio manager at Angel Oak, where among other things, he runs the firm's strategic credit fund, an interval fund traded under ticker symbol ASCIX that you can learn more about by going to AngelOakFunds.com. To learn more about interval funds, closed-end funds, and business-development companies generally, go to AICAlliance.org, the website for the Active Investment Company Alliance. Colin McBurnette, thanks so much joining me on The NAVigator.

COLIN McBURNETTE: Thanks so much for having me.

CHUCK JAFFE: So I want to start with the housing market because, well, you guys are buying mortgages and mortgage credits and securitized credits, and the housing market we hear a lot of headlines about, "What's happening in housing?" But what's happening at that surface level is very different from what's happening at your level, where you're talking about buying mortgages and the rest. We've got a high rate, high inflation market, things are changed dramatically for consumers, but what's happening for that market for credits and how is it both holding up and changing during these times when we hear so much about housing?

COLIN McBURNETTE: Sure, so the ultimate source of repayment when we think about investing in mortgage credit is clearly the mortgage borrower, and then subsequently if the mortgage borrower were to fall on hard times and go through a loan modification and forbearance program and not survive, is the house is the ultimate source of repayment for a mortgage if a borrower is unable to make those payments. So we spend a lot of time talking about both; what's going on with mortgage borrowers or the US consumer and what's going on in the housing market more generally? I think since the Global Financial Crisis everybody's been waiting for housing to happen again. Housing was not a cyclical good, or it was never thought of as a cyclical good, I suppose, heading into a global financial crisis, in fact, it held its value or even improved in value through nine of the prior 11 recessions. It tends to be particularly sensitive to demographic changes, to supply and demand dynamics that exist, and it has an employment and overall macro sensitivity as well, but that's really not the driving force behind housing sustaining its value. And if we look with what's gone on over the past year and a half with the Fed waging war on inflation, taking rates up 500 basis points, mortgage rates going from record lows in the twos up into the mid-sevens, and yet if

you start to look at research estimates for the next Case-Shiller print, we may be back in positive territory year over year, which would put us at or back through the all-time highs in the value of the housing market. And I think a lot of that's been driven by a few dynamics; one, the supply and demand dynamic that exists in the US, where we've underbuilt housing dramatically for the past 15 years. Higher rates, as opposed to in the pre-crisis period where higher rates were filtering through to floating-rate mortgages and ultimately increasing mortgage payments on a monthly basis and leading to excess supply coming online in the housing market, it's had the opposite effect this time. There's been no floating-rate origination since 2009, it's only about 3% of all original post-Global Financial Crisis, and as a result it's serving more as a form of rent control. People are staying in their homes to benefit from that low mortgage payment, they're not moving as fast as they once were, and so you have this all-time, or near all-time low in supply in the housing market, and I think that is contributing to, when you're faced with the demand from the millennial generation, the largest in US history, continuing to buy homes and expand their footprint in their house, this really tight market for housing that continues to push prices higher. As a result, I think that the housing component of mortgage credit looks incredibly robust, we find it to be very resilient even through different stressed scenarios that we would contemplate for the US economy. And the mortgage borrower I think most importantly is in an incredibly strong position as we head into this potentially end, certainly late cycle but potentially end of this cycle, as they're using smaller portion of their disposable income than ever before to service their debts, they have a tremendous amount of equity in their homes, and underwriting standards for getting a new mortgage since 2012 have been incredibly restrictive. Mortgages are about 1/8th as available today as they were at the height of excess prior to the GFC, and they're only about a third as available as they were even going back to 2003. And so you have this asset in mortgage credit with a very strong mortgage borrower in place on top of an asset class in the US housing market that's exhibiting I think very strong and very stable fundamentals, and so we're very comfortable investing in credit backed by that even at this point in the cycle. And then if we look at spreads in that market, last year was a very trying year for mortgages, agency and non-agency, or government guaranteed and non-government guaranteed mortgages, in that as a mortgage owner you're inherently short volatility because the borrower owns all these options to pre-pay, with the rate volatility

specifically. With the Fed's war on inflation you saw rate volatility spike to incredibly high levels and remain there for a long period of time, and it pushed nominal spreads for agency mortgages to the widest levels that we'd seen since 2009.

CHUCK JAFFE: Yeah, I was going to say, I didn't remember even 2009, I don't know that I've ever seen it. That was one of the things I saw in a number of different commentaries where people were saying, "The spreads are huge." That should make it a great time to be investing in mortgage credit, right? The bigger the spread, the easier the pickings would be the way to put it?

COLIN McBURNETTE: Yeah. Yes, we think so. This period has been defined by you're able to receive more from a nominal spread perspective more relative to owning corporates than at any other point in the post-Global Financial Crisis period, and quite frankly I think at any other point since 2000, and so you're just compensated a whole lot for taking on what is some convexity in the form of these mortgages. Though if you're buying something that's deeply discounted, you actually could be in positively convexed territory, but you've got a little bit of uncertainty around the timing of your repayment. But if you can deal with that, which I think people are paid more than adequately to do so right now, and that's before you even get to, in our opinion, the crux of the issue, which is that the housing market and mortgage borrower to us just looks much more robust than the corporate debt environment in the US.

CHUCK JAFFE: In a market that you're describing where if I broke out the statement and you gave a longer answer there, there'd be parts of where I'd go, "Ooh, that would have concerned me," and "This would be okay," and "This is looking better." How much do you benefit in this kind of market from the interval structure where based on what's happening and some of the headline risk in the housing market and the mortgage market, you kind of can't do anything, you're locked in a little bit, so the result of that is things should be better? How much is running an interval fund helping you in these conditions?

COLIN McBURNETTE: I think the interval fund structure is incredibly valuable right now to managers and investors. With what the Fed has done moving away from QE during which they were inserting liquidity into the market and into Q2 where they're pulling the liquidity out of the market, liquidity's naturally more expensive, crossing bid/ask becomes more expensive. You've had an environment where it was actually 2022 that was the largest

outflow year ever from credit-based mutual funds and ETFs, and so those outflows necessitate selling, and they necessitate selling in an environment where liquidity was relatively very expensive. And so to the extent that you're able to seed liquidity on an interval structure and be counter cyclical, you're able to as a manager purchase assets with very wide bid/asks when people are selling, and you're not forced to sell in markets when markets were selling as expensive. And so I think the interval structure continues to demonstrate its benefit to investors through the returns I think that it can generate by not having to be subject to the retail whims that we've seen over the past 20 months.

CHUCK JAFFE: And in housing and mortgages, lots of retail whims. Colin, really interesting, thanks so much for joining me on The NAVigator to talk about it.

COLIN McBURNETTE: Thank you so much for having me.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, that's me, why don't you check out my show on your favorite podcast app or by going to MoneyLifeShow.com? To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. Thanks to my guest Colin McBurnette, senior portfolio manager at Angel Oak, learn more about the firm and its offerings at AngelOakFunds.com. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following along on your favorite podcast app. We'll be back with more closed-end fund talk next week, until then, happy investing everybody.

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