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Strategy in Focus: Seer and Semper bullish on new issue securitizations

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Structured credit managers are optimistic about the current opportunities in new issue structured products.

Two hedge fund managers that are bullish on post-crisis securitization and beat the Absolute Return Mortgage-Backed Securities Index's 4.66% return by nearly double last year are $3.4 billion Semper Capital Management and $1.2 billion Seer Capital Management.

Absolute Return's David Graubard recently sat down with Semper chief executive Greg Parsons and Seer's co-chief investment officer and co-founder, Richard d'Albert, to discuss the structured credit space.

Both executives agree that the opportunities and stability of returns from securitization funds will continue. "As we look to the future, we remain encouraged by the opportunity set and continue to believe non-agency (residential) MBS offers some of the most compelling risk-adjusted returns," says Parsons. "We expect more investors to enter the space that are looking for the yield and safety offered by U.S. mortgages, especially in this low rate environment."

As seen last year, securitization funds can withstand a broad range of scenarios and offer lower volatility by investing in higher quality cash flows, which create substantial loss cushions if defaults rise.

While Semper's holdings include legacy short-maturity residential mortgage-backed securities, the firm remains "cognizant of the decreasing size of the market" as the collateral continues to pay-down so the firm also buys new RMBS products. "Most of the legacy RMBS ($360 billion outstanding) sector continues to provide increasingly stable carry," says Parsons.

Both Parsons and d'Albert say next generation (post-crisis issuance) securitization is on a growth trajectory and offers attractive structural enhancements, particularly across non-agency RMBS and commercial mortgage-backed securities. Non-agency RMBS grew 39.2% between 2017 and 2018, according to data from Bank of America.

The two firms differ in their focus. In addition to next generation MBS, Semper looks for opportunities in short-dated pre-crisis RMBS and has smaller exposure to commercial mortgage loans because of their ties to the broader economy. Seer issues and originates over $1 billion per annum in RMBS. It also negotiates syndicated bank commercial real estate loan pools in CMBS deals using its influence as an anchor B-piece buyer. "Without selling the B-piece, the CMBS transaction stops," says d'Albert. "The CMBS B-note is the riskiest and hardest tranche to sell for underwriters."

Seer focuses on three core asset classes to generate alpha: RMBS, CLOs, and CMBS and tries to get as close as it can to the underlying loan selection process of the assets included in new issues. For Seer's founders, chief executive Phil Weingord and d'Albert, who at different times ran global securitization for Deutsche Bank out of New York before starting the hedge fund — issuing securitizations comes naturally.

"For Seer it's all about post-crisis opportunities, pre-crisis securities are mostly too short in duration for us," d'Albert says. "In CLOs we are predominantly focused on BB/BBB securities in the new issue market, either private or public markets. Some secondary trading can create alpha; however, it is challenging to get large positions. Most funds are returning high single-digit to low teen annual returns consistently."

Seer is one of the few hedge fund managers that originates and issues new RMBS deals. The RMBS issuance allows the firm to earn carry and "shape" the credit quality of the assets going into the fund, d'Albert says.

The firm issues quarterly through its Residential Mortgage Loan Trust shelf , accumulating collateral at a pace of $100 million a month. Housing loan borrowers in the transactions have a weighted average FICO of approximately 700 and are actively screened for credit quality, which Seer manages. "Defaults have been minuscule, under 0.1% cumulative, since starting the program five years ago," d'Albert adds.

According to d'Albert, Seer is one of the largest repeat CMBS B-piece investors, which includes global firms such as KKR, Rialto Capital Management, and Oaktree Capital Management. He notes that the shrinking of the conduit or syndicated commercial loan market, which is dominated by investment banks, puts added pressure on underwriters to structure more stable transactions and give investors a louder voice. According to Kroll, conduit CMBS will decline from $48.5 billion in 2017 to an estimated $30 billion by yearend.

"Seer invests $100 million per year in CMBS B-piece new issues approximately split between four to five deals," says d'Albert. "The advantage is the opportunity to shape the investment by having a voice in the composition of the target commercial loan portfolio of the new issue CMBS deal over 8-10 weeks leading up to pricing and with active monitoring of the outstanding collateral thereafter."

From a credit perspective, CMBS underwriting has improved markedly since increased risk-retention regulation rules were put into place at the end of 2016 with the introduction of Dodd-Frank. The regulations require either issuers or B-piece investors to keep a 5% portion of every CMBS deal they sell. This includes investment banks that are active issuers of syndicated conduit deals and use the product to remove commercial real estate loans from their books. This increased regulation and lower commercial lending volume by banks has created compelling investment opportunities, according to d'Albert, because of a stronger alignment of interest, especially in comparison to pre-crisis deals.

D'Albert also believes that better value and liquidity is found in the CLO mezzanine versus the CLO equity market. He said the firm's CLO mezzanine tranches have approximately 8% hard credit enhancement and the underlying loans have 60-70% recovery rates. The default rate on US leveraged loans was 1.76% in July, on a trailing 12-month basis, according to data from S&P Global Market Intelligence. This is below the historical 3% per annum average.

Regarding rates, the two funds are positioned defensively. Seer has kept interest rates risk-neutral since its inception. While Semper's Parsons says: "Despite the Fed's more dovish posturing, we believe in the merits of owning shorter duration and high flowing-rate exposure securities."

Semper Capital's Midas Fund was up 4.06% through July and Seer's Capital Partners Fund gained 5.7% through July, according to Absolute Return data.
