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Collateral Advantage: The MBS Market Offers a Kaleidoscope of Opportunities

Many community bankers are beginning to get serious about their bond portfolios as liquidity has normalized, and rates have stayed, shall we say, buoyant. It occurs to me that the still-visible 2022-23 selloff has created at least one byproduct that is both unusual and tangibly beneficial for future performance.

Portfolio managers continue to embrace mortgage-backed securities (MBS) for several reasons. One is that MBS are loan surrogates. Since community banks are lenders by definition, the monthly cash flows are well understood and a nice fit for the balance sheet and interest rate risk. Using 600-plus banks in The Baker Group bond accounting population as a proxy, nearly half of all the dollars in these portfolios is in some type of MBS: fixed or floating, straight pass-through, or collateralized mortgage obligation (CMO).

Each MBS pool is backed by hundreds, if not thousands, of conforming mortgages that have been underwritten to uniform standards. This allows securities to be compared with one another and for prepayment histories on given cohorts to be a basis to project future behavior. This also is one reason for the terrific liquidity in the pass-through market.

There have been several lengthy periods recently in which an investor in the mortgage market was limited to buying bonds with a small range of coupons. For much the past 18 years or so, "small range" has been synonymous with "low." In nine of those years, fed funds were anchored at 25 paltry basis points (0.25%). Although there isn't a high degree of correlation between overnight rates and 30-year mortgages, when money-market yields are "accommodative" (Fed speak), it's not likely that longer rates are historically impressive.

The Opportunity

So now, as community bankers try to set up their bond portfolios to take advantage of what's available, there is a wide range of options. One time-tested strategy is to diversify. (In fact, when is that not a good idea?) Sometimes that means issuer name, weighted average maturity (WAM), or even age of the pools. In 2026, it can also mean coupons.

Let's say you're in the market for 15 year stated final MBS, and you ask your favorite brokers to show you several examples. There currently is a supply of securities with pass-through rates ranging from 1.5% up to 5%. Each incremental bump in rate will, of course, have an increase in price. Another variable you'll notice is the deep-discount bonds with the lower coupons were hatched every bit of five or six years ago, so they have a correspondingly short weighted-average maturity (WAM) and average life.

Spread the Wealth

Another piece of good news related to this is that even the higher coupons have only modest premiums, especially compared with 2021. If investors are unsure of their favorite flavor, they can buy several different structures, thereby guaranteeing they will be pleased with at least some of the new purchases. (A pessimist might say they'll be guaranteed to be displeased with some, but I'm going with the affirmative.)

What also is clear is that an MBS with a below-market coupon will look very different from a "current coupon" in terms of prepayments, average lives, price volatility and, yes, yield. Currently, a 15-year 2% security is priced around 8 points below par, and the lifetime prepayment speed on the entire cohort is well under 8% annually, which is very slow. (It may be helpful to know that the average homeowners' mortgage rate was 4.4% in June 2026.) One can expect these low coupons to continue to prepay very slowly, producing minimal monthly cash flow in the near term. Offsetting these slow speeds, scheduled principal is beginning to throw off some cash flow, and stated final maturities are ten years or less.

If buyers are so inclined, they could layer in some 15-year MBS with, say, 5.0% coupons, which, at present, are priced close to

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par. Because the borrowers' rates will probably at some point be "in the money" to refinance, these pools can have shrinking average lives if rates fall, and more cash flow than discount pools. However, most relevant is that the portfolio will now be insulated against both rising and falling rates, and average risk/reward metrics of the multiple pools would probably beat any one security currently available.

Today's lesson is that the debris of the past has created a simple-to-apply strategy of buying a wide range of coupons and, in effect, hedge your interest rate bets. Doing so can turn the collateral damage of 2022 into your collateral advantage of 2026.

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