



Portfolio 2011

A compendium of investment perspectives from J.P. Morgan Asset Management

INVESTMENT INSIGHTS

U.S. FIXED INCOME

Re-REMICs: A New Lease on Life for MBS?

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OVER THE LAST FEW YEARS, triple-A-rated mortgage-backed securities have undergone extensive downgrades. Many have fallen below investment grade and appear likely to take principal writedowns. The credit deterioration has precluded many money managers and regulated institutions from investing in these assets and/or forced them to sell, either to comply with investment policies or to obtain better risk-based capital treatment. To help address this problem, Wall Street firms have created and marketed Re-REMICs—Re-securitizations of Real Estate Mortgage Investment Conduits. We believe that this solution could well afford investors an opportunity to rebuild non-agency mortgage positions—and for investors qualified to participate in 144A private placements, it could offer a new and valuable source of investment grade securities. Not coincidentally, it could also provide a way out for the frozen mortgage market.

What is a Re-REMIC?

A Re-REMIC is simply a trust that has been created to own one or more existing mortgage-backed residential or commercial securities. Prior to the recent mortgage credit crisis, Re-REMICs were primarily created to meet investors' specific



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cashflow needs. To that end, a dealer might have purchased an existing triple-A-rated, non-agency RMBS security, placed it into a trust, and then issued two or more new securities from the trust, creating, for example, floaters and inverse floaters from an underlying fixed rate security. These new securities, when combined, still carried the same cashflow and rating as the underlying security.

Beginning in early 2009, dealers began creating Re-REMICs to address the market's escalating concerns about residential mortgage-backed security credits. In the simplest structures, the dealer would buy an existing security that had been downgraded to non-investment grade, or was likely to be re-rated, and place the security in a trust. The trust would then issue two new securities that were sequential in terms of principal repayments:

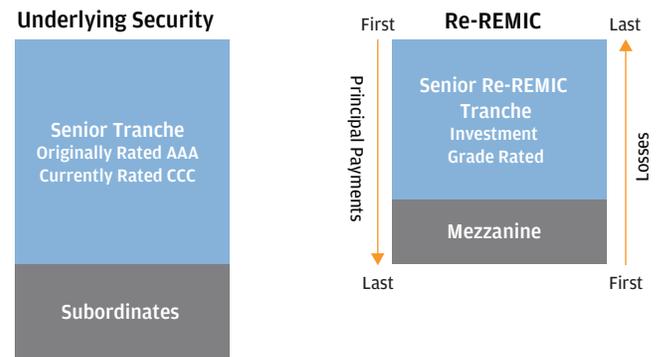
- The senior security, ideally rated triple-A or at least rated investment grade, would receive all principal payments from the underlying security.
- The senior security would not take any loss until the mezzanine security was written off.
- The mezzanine security in the Re-REMIC was subordinated to the senior security and would bear the first loss position for any realized losses.
- The mezzanine security would not receive any principal until the senior security was fully paid off.

Newly issued Re-REMICs are typically exempt from SEC registration under rule 144A and are often rated by only one NRSRO, or nationally recognized statistical rating organization. These factors can limit liquidity on Re-REMIC securities compared to SEC-registered public securities. Nevertheless, in our opinion, Re-REMIC securities look fundamentally attractive and offer high quality investment opportunities with favorable yields and risk/return profiles. Additionally, Re-REMICs are fully modeled by such leading analytics providers as Intex, Trepp, Bloomberg and Loan Performance, with all documents and collateral details on both the underlying public security and Re-REMIC security readily available. Likewise, all major dealers actively trade and make markets in Re-REMIC securities.

Exhibit 1 shows a typical structure of the underlying deal, as well as the Re-REMIC trust.

Stronger safety net: A Re-REMIC segregates the investment-grade portion of an existing MBS, ensuring senior holders have priority

EXHIBIT 1: RE-REMIC STRUCTURE



Source: J.P. Morgan Asset Management.

Re-REMICs vs. CDOs

Although both Re-REMIC and CDO structures package securities into a trust which issues new securities that are initially rated investment grade, there are a number of significant differences between the two structures. First, asset-backed CDOs, especially subprime asset-backed CDOs issued between 2004 and 2007, contained many underlying securities—sometimes up to 100. They often included heavy allocations to mezzanine and subordinated subprime securities, originally rated BBB- to AA, and/or securities issued from other CDOs. Since the underlying subprime asset-backed securities and CDOs were created as complex, highly leveraged, credit-intensive investments, small changes in base credit and prepayment assumptions led to amplified performance deterioration and ratings downgrades as the housing market corrected.

Second, one of the primary theories behind the CDO structure was that if the asset classes and sectors represented in the CDO were relatively uncorrelated, the CDO manager could reduce the risk inherent in each security by packaging them together into a CDO and issuing new credit- and cashflow-tranched securities. The ratings on many of the resulting CDO tranches were subsequently higher than the ratings on the underlying securities. In reality, many asset-backed CDOs issued during the 2004 to 2007 period held only strongly correlated, poorly performing subprime securities with insufficient credit protection. Once the housing market crashed, nearly all of the



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mezzanine and subordinated subprime ABS securities suffered similar degrees of loss. This caused the write-off of a significant portion of the assets in the CDO structures.

Third, many of the mezzanine and subordinated RMBS and ABS that were placed in CDOs contained collateral performance triggers designed to protect the senior holders of the underlying trust. Once delinquency and loss rates skyrocketed, the triggers failed, immediately locking out the mezzanine and subordinated securities from receiving any principal. This meant little, if any, principal cashflow went into the CDO structure to pay bondholders.

Re-REMIC Rejuvenation

In contrast, most of the Re-REMICs that have been created over the past 18 months placed a senior bond that was originally triple-A-rated into the Re-REMIC. Many of the underlying securities placed into these Re-REMICs are currently paying principal as well as interest in any case, and their principal priority status is not subject to collateral performance tests or triggers. In addition, a Re-REMIC is a static collateral trust and does not change over time.

Most of the old CDOs, on the other hand, allowed the CDO manager to actively manage the CDO's securities during the first three to five years after issuance. This meant that the CDO manager, who earned a management fee and held at least a portion of the equity or first loss security in the CDO, could alter the composition of the trust's collateral, subject to certain specified conditions, either by reinvesting the underlying security cashflows or replacing existing higher quality, lower yielding securities in the CDO with newly originated higher yielding securities.

A new Re-REMIC typically boosts the credit protection on a mortgage-backed security that may have been written down but has not been written off. The underlying security still retains positive cashflows, despite having fallen below investment grade. Tested across a broad range of prepayment and credit scenarios, although it might still be subject to writedowns, it would return the majority of its principal, plus interest. The additional triple-A-rated credit protection reduces

the leverage in the underlying security substantially enough to restore a portion of its cashflows to investment grade, effectively eliminating their writedown exposure.

Buying on the Analytical Dip

In December, Standard & Poor's placed over 1,000 Re-REMIC securities on review for downgrade. S&P conceded that it had incorrectly analyzed the interest payment allocations across the structures. Some trusts, instead of making interest payments according to the seniority of the tranches, allocate these payments on a pro-rata basis. Furthermore, the rating agencies may not have considered the impact of loan modification scenarios on cashflow.

The announcement underscored the need for individual security analysis. Indeed, our internal analysis has found that the flow of funds is not consistent across issues, though many are, in fact, structured with interest payments made strictly according to the seniority of the tranches, not pro rata. Our scenario testing also found that some senior Re-REMIC securities could sustain principal losses, even using our base case assumptions. With the strength of our analytic process, however, we continue to be buyers of Re-REMICs, and we believe that any softness in the market created by S&P's announcement may provide an additional opportunity for well-informed investors.

A Structure for Knowledgeable Investors

Aside from this "information premium," robust Re-REMICs could also gain a scarcity benefit in the coming year. Regulations proposed by the SEC would make Re-REMICs more difficult to create, reducing or eliminating the supply of new issue securities. We expect the proposal to be reworked before it is finalized, but in any case, we don't expect it to affect already issued bonds. The potential scarcity of Re-REMIC structures that results may enhance the opportunity in existing securities.

Re-REMICs are structurally different from CDOs and have provided a viable means to re-enter the structured securities market. In our view, many of today's senior Re-REMIC securities offer credit protection sufficient to shield investors from



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rising defaults and further declines in home prices. As with any structured security, investors need to remain disciplined and perform thorough credit and structural reviews on each Re-REMIC, including analysis of the underlying flow of funds combined with scenario stress testing. Ultimately, however, investors with the skill, experience and discipline to value non-agency mortgage credit and structured securities effectively should find attractive value and total return opportunities in Re-REMICs.

EXPANDING HIGH QUALITY NON-MBS SUPPLY

Real Estate Mortgage Investment Conduits (REMICs) are bonds created from pools of mortgages. Re-REMICs are securities created from the underlying cash flows of existing REMIC bonds. Dealers create Re-REMICs by taking an existing security and placing it in a trust. The trust then issues two new bonds backed by the cash flows of the original security—one bond being senior to the other. The senior bond in the Re-REMIC structure receives the credit support that is left on the original bond, plus additional credit support in the form of the new subordinate bond issued by the Re-REMIC trust to provide protection from losses on the collateral.

For example, a dealer may take an Alt-A vintage 2006 security with \$1,000,000 face value, place it in a trust and issue a \$500,000 senior bond and a \$500,000 subordinate bond. The senior bond receives additional credit support from the subordinate bond.

Depending on the level of risk of the original security's underlying collateral, the additional credit support on the new senior Re-REMIC bond will typically range from 5% to 90%, enhancing its protection from future downgrades.



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