Agency MBS Demystified: How Weitz Utilizes Mortgage-Backed Securities

January 3, 2025

Weitz | INVESTMENT MANAGEMENT

At Weitz, our approach to capital allocation in the U.S. debt market prioritizes flexibility and value. We aim to identify, evaluate, and allocate to opportunities that we believe offer the most compelling relative value at any given point in time, index-eligible or not.

> "Our investment approach is simply aimed at seeking out the most attractive, risk-adjusted opportunities. We believe a diversified portfolio encompassing broad market exposure, including benchmark – but, as importantly, non-benchmark fixed rate and floating rate investments is a competitive advantage historically, and continues to be, in today's environment." – Tom Carney, CFA®, Weitz co-head of fixed income

Agency mortgage-backed securities (MBS) illustrate this philosophy. At $9 trillion in size, agency MBS represent approximately 15% of the U.S. fixed income market and 25% of the Bloomberg U.S. Aggregate Bond Index (Agg)[i].

These securities are pools of individual residential mortgages issued by government-sponsored enterprises (GSEs) like Fannie Mae, Freddie Mac, and Ginnie Mae. While Ginnie Mae's guarantees are explicitly backed by the full faith and credit of the U.S. government, Fannie Mae and Freddie Mac are widely perceived to have an implicit guarantee of principal and interest payments.

Agency MBS, second only to U.S. Treasuries in liquidity, trade at an average daily volume of $308.8 billion[ii], underscoring their market depth and adds to their stability. With most loans within these pools classified as conventional, with 99% fixed-rate, and approximately 85% on 30-year terms[iii], agency MBS offer an attractive combination of scale, liquidity, and stability.

HOW DID THE CURRENT RELATIVE VALUE OPPORTUNITY IN MBS ARISE?

The current opportunity in agency MBS stems from significant shifts in market dynamics over the past 15 years.

1. The Role of the Fed

Before the Global Financial Crisis (GFC), the Federal Reserve had no exposure to agency MBS. In response to the crisis, it initiated quantitative easing (QE), amassing nearly $2.75 trillion in agency MBS holdings. This intervention artificially suppressed mortgage rates, which, in our view, resulted in less attractive opportunities for investors. By June 2022, the Fed reversed course, implementing quantitative tightening (QT), thus— halting MBS purchases and gradually reducing its MBS holdings. [iv]

2. Bank Failures and Forced Sales

In early 2023, the failures of Silvergate Bank, Silicon Valley Bank and First Republic Bank triggered a significant sell-off in MBS. Regional banks, the largest holders of agency MBS (owning approximately 33% of all outstanding[v]), faced regulatory pressures and shifting priorities, leading to a decline in demand.

3. The Decline of GSE Holdings

Since the GFC, the GSEs have dramatically reduced their holdings of agency MBS, dropping from 17% to less than 1% of the outstanding universe as of December 2024 .

With major buyers retreating and interest rate volatility rising, MBS spreads widened significantly, creating an attractive relative value opportunity. [vi]

WHY HAS WEITZ INCREASED MBS ALLOCATION?

For most of its first nine years, the Weitz Core Plus Income Fund had little to no agency MBS exposure, reflecting market conditions where relative value opportunities were more compelling elsewhere.

By 2023, market dynamics shifted, prompting the fund to meaningfully increase its MBS allocation. Starting in March 2023, the allocation grew steadily, and as of December 2024, agency MBS now accounts for more than 30% of the fund.

A SHIFT IN RELATIVE YIELDS

Historically, investment grade (IG) corporate bonds offered higher yields than agency MBS. However, in May 2023, that dynamic reversed, with agency MBS outperforming IG corporate bonds over the past 18 months solidifying their attractiveness, as shown in the charts below.

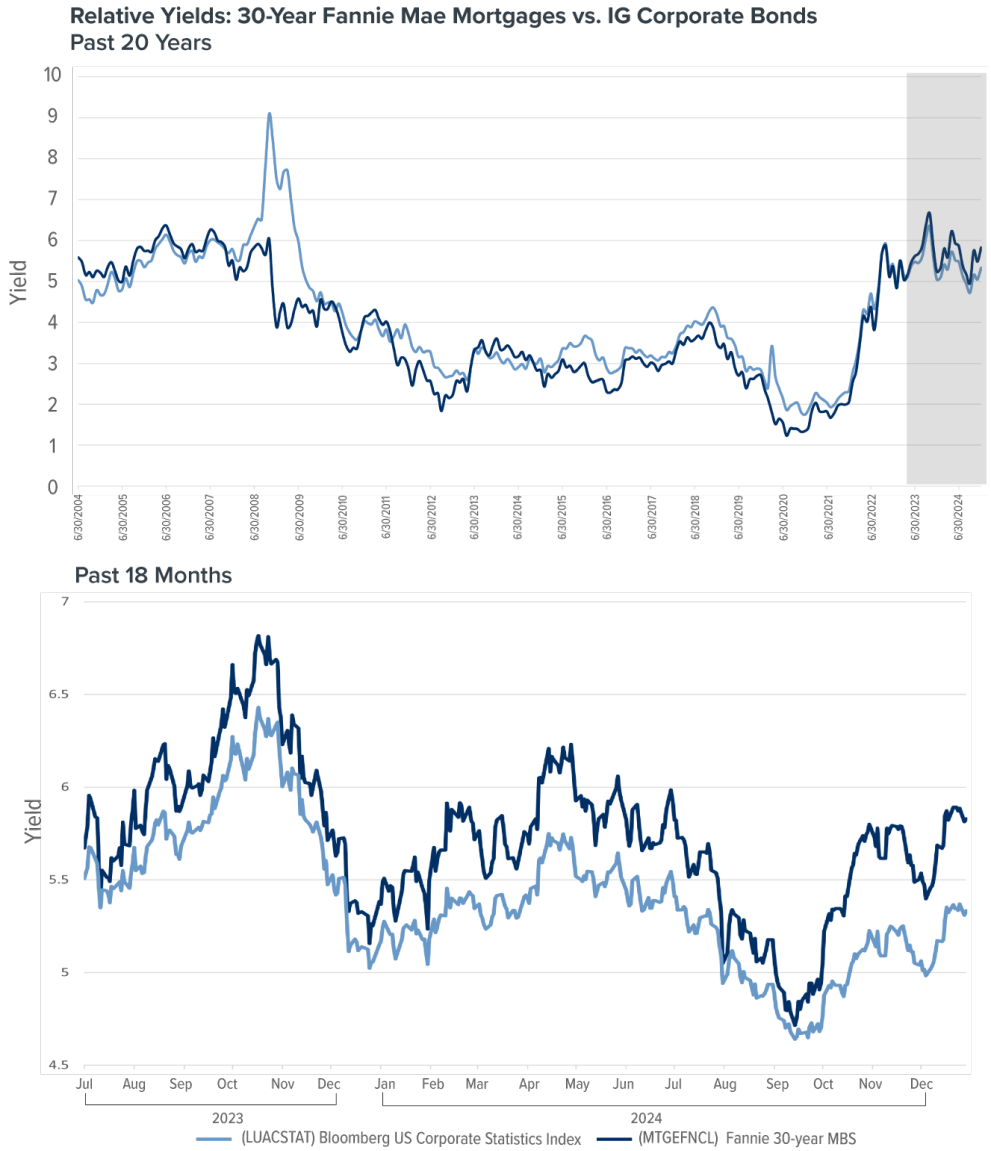


Chart 1: Past 20 Years Monthly Yields, 6/30/2004 - 12/31/2024 **Chart 2:** Past 18 Months Daily Yields,7/3/2023 - 12/31/2024
Source: Bloomberg

THE CASE FOR AGENCY MBS

While IG corporate spreads remain tight relative to historical standards, agency MBS stand out due to:

1. Higher Yield: Attractive relative value

2. Credit Quality: Perceived explicit or implicit U.S. government guarantees

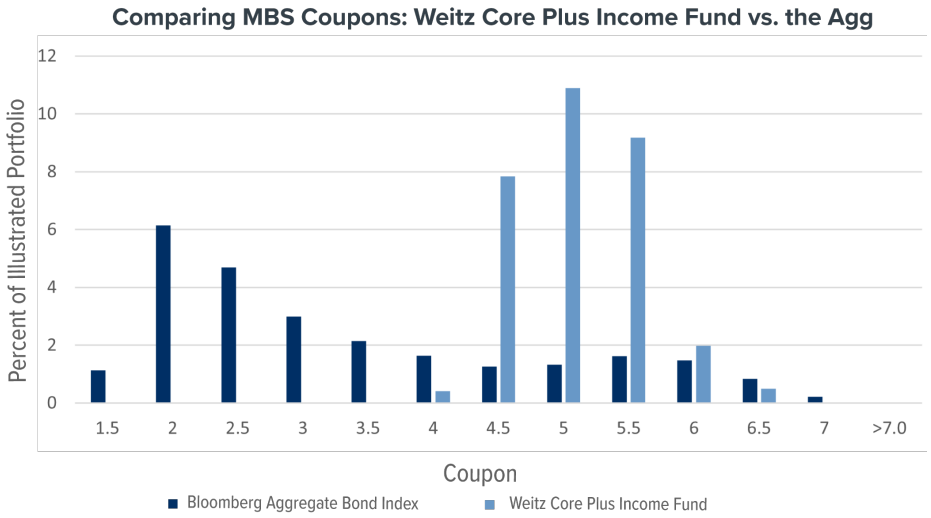
3. Liquidity: Second only to Treasuries in trading volume

This combination of higher yields, lower credit risk, and enhanced liquidity led us to strategically increase agency MBS exposure, positioning it as a key driver of risk-adjusted returns in the fund.

HOW DOES WEITZ AGENCY MBS EXPOSURE COMPARE TO THE AGG?

Since the Agg has maintained consistent exposure to agency MBS, its holdings include older vintages with significantly lower coupons. In contrast, the Weitz Core Plus Income Fund has focused on newer, higher-coupon vintages that reflect current market conditions.

The recent tightening cycle and rising interest rates drove 10-year Treasury yields higher, leading to increased yields on newly issued agency MBS. While all MBS vintages are broadly priced off the 10-year Treasury, newer "current coupons" offer a more attractive yield relative to older vintages, as illustrated to the right.



Source: Bloomberg as of 12/31/2024

A STRATEGIC DISTINCTION

At first glance, the fund's increased agency MBS might appear to track the Agg or follow the crowd during a volatile period. However, this shift reflects a deliberate, value-driven strategy to capitalize on changing and relative value opportunities.

This ability to adapt and strategically allocate capital reflects the philosophy behind the Weitz Core Plus Income Fund—driving results through flexibility and conviction.

[i]Source: SIFMA, Morgan Stanley Research

[ii]Agency MBS's average daily trading volume reflects the 12 months ended 12/31/2023. Source: SIFMA

[iii]Source: Bloomberg, Morgan Stanley Research - MBS Overview, October 15, 2024

[iv]https://www.reuters.com/business/feds-qt-plan-then-now-2022-04-06/

[v]Source: SIFMA, Treasury, Federal Reserve, Page 67 of MS- MBS Overview

[vi]Source: Fannie Mae, Freddie Mac, Page 73 of Morgan Stanley- MBS Overview

IMPORTANT DISCLOSURES

Holdings are subject to change and may not be representative of the Fund's current or future investments.

The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

Consider these risks before investing: All investments involve risks, including possible loss of principal. Market risk includes political, regulatory, economic, social and health risks (including the risks presented by the spread of infectious diseases). Changing interest rates may have sudden and unpredictable effects in the markets and on the Fund's investments. The Fund may purchase lower-rated and unrated fixed-income securities, which involve an increased possibility that the issuers of these may not be able to make payments of interest and principal. See the Fund's prospectus for a further discussion of risks.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.

Weitz Securities, Inc. is the distributor of the Weitz Funds.