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ASSET MANAGER'S LENS

Mortgage-Backed Securities in Today's Housing Market



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Unlike traditional bonds with fixed maturities, mortgage-backed securities' (MBS) cash flows are **path-dependent**, influenced by homeowner behavior and interest rates. This makes MBS distinct from Treasuries or corporate bonds and introduces unique risks and return drivers.

Broadly, the MBS market can be divided into:

- **Agency MBS** — issued or guaranteed by government-related entities
- **Non-Agency MBS** — privately issued securities without government guarantees

Each plays a different role in fixed income markets.

A **Mortgage-backed security (MBS)** represents an ownership interest in a pool of residential mortgage loans. Homeowners make monthly payments of principal and interest, and those cash flows are passed through to investors after fees.

THE HOUSING BACKDROP: SUPPLY CONSTRAINTS, POLICY RESPONSES, AND MARKET IMPLICATIONS

Housing affordability and availability continue to be central economic challenges in the U.S. Years of underbuilding, demographic pressures, and higher mortgage rates have contributed to a housing market that is widely viewed as supply-driven, rather than the result of excessive demand.

In response, policymakers have pursued a mix of demand-side and supply-side initiatives. On the demand side, recent efforts have included directing government-sponsored enterprises (GSEs) to increase purchases of existing mortgage assets in an effort to support liquidity and affordability in certain segments of the market. On the supply side, proposals such as limiting institutional ownership of single-family rental homes have been discussed as a way to increase housing availability for owner-occupiers.

However, the scale of these initiatives is modest relative to the overall U.S. housing market. Institutional ownership represents only a small fraction of total housing stock, and incremental GSE purchases are limited compared to the size of the mortgage universe. As a result, the ultimate efficacy of these measures remains unclear, particularly in addressing long-term supply constraints.

For investors, these policy actions can still matter. Even when outcomes are uncertain, changes in regulation, liquidity provision, and market participation can influence how different segments of the mortgage market trade, especially within mortgage-backed securities (MBS).

Understanding how the MBS market works — and how agency and non-agency sectors differ — can help advisors better interpret both housing headlines and fixed income performance.

AGENCY MBS: THE CORE OF THE MORTGAGE MARKET

Agency mortgage-backed securities are issued or guaranteed by one of three entities:

- **Ginnie Mae**, which carries an explicit U.S. government guarantee
- **Fannie Mae and Freddie Mac,** government-sponsored enterprises (GSEs) with implicit government support

Because of these guarantees and/or support, agency MBS are generally considered high-quality credit instruments, despite being backed by residential mortgages.

SCALE AND MARKET ROLE

Agency MBS represent one of the largest and most liquid fixed income markets globally and make up a meaningful portion of broad bond benchmarks such as the Bloomberg U.S. Aggregate Bond Index. As a result, many "core" bond portfolios hold agency MBS either intentionally or by benchmark design.

PREPAYMENT AND EXTENSION RISK

Agency MBS differ from traditional bonds due to prepayment optionality:

- When interest rates fall, homeowners may refinance, returning principal sooner than expected (prepayment risk).
- When rates rise, refinancing slows, extending the life of the security (extension risk).

This creates negative convexity, meaning agency MBS can behave differently than Treasuries during periods of rate volatility.

WHY INVESTORS USE AGENCY MBS

Agency MBS have historically offered yields above Treasuries as compensation for mortgage-specific risks, while maintaining strong liquidity and government-related credit support. For many portfolios, they serve as a core income-generating sector within high-quality fixed income.

NON-AGENCY MBS: BEYOND GOVERNMENT GUARANTEES

Non-agency MBS are privately issued mortgage securities that do not carry GSE guarantees or support. As a result, investors assume more direct exposure to housing collateral and deal structure.

JUMBO AND OTHER NON-CONFORMING MORTGAGES

Non-agency MBS often include loans that don't meet GSE standards due to loan amount, credit, or other factors, including jumbo mortgages. These borrowers are frequently higher-income households purchasing more expensive homes, but the loans fall outside agency eligibility.

STRUCTURAL CREDIT PROTECTION

Unlike corporate bonds, non-agency MBS rely on securitization structures — often referred to as structural credit enhancement — including subordination, overcollateralization, reserve accounts, and excess spread. Losses are absorbed first by junior tranches before impacting senior bonds.

RISK AND RETURN PROFILE

Non-agency MBS typically offer higher yields than agency MBS to compensate for credit and structural risk. Performance is driven more by housing fundamentals, borrower behavior, and underwriting quality than by government policy alone.

NON-QM MORTGAGES: FILLING GAPS IN POST-GFC LENDING

Following the Global Financial Crisis, mortgage underwriting standards tightened significantly under the Ability-to-Repay and Qualified Mortgage (QM) framework. While these changes improved overall credit quality, they also narrowed the definition of eligible borrowers.

Non-Qualified Mortgages (Non-QM) emerged to serve borrowers who do not meet strict QM criteria but can still demonstrate an ability to repay — such as self-employed individuals, real estate investors, or borrowers using alternative income documentation.

When securitized, **Non-QM RMBS** fall within the non-agency MBS universe and tend to offer higher yields to reflect their differentiated credit profile. Importantly, today's Non-QM market operates under post-GFC regulatory oversight and is structurally distinct from pre-crisis subprime lending.

WHERE MBS FIT: A COMPARATIVE VIEW

Sector	Primary Risk Driver	Credit Support	Key Structural Risk	Typical Portfolio Role
U.S Treasuries	Interest rates	Full U.S. government	Duration risk	Liquidity, capital preservation
Investment-Grade Corporates	Credit + Interest Rate Risk	Issuer balance sheet	Credit & downgrade risk	Income, spread exposure
Agency MBS	Rates + mortgage behavior	Ginnie (explicit), GSEs (implicit)	Prepayment & extension	Core income, diversification
Non-Agency RMBS	Housing collateral	Structural credit enhancement	Credit & structure	Incremental yield
Non-QM RMBS	Borrower cash flows	Structural credit enhancement	Underwriting dispersion	Higher income potential

Housing market challenges and policy responses will continue to evolve, and their ultimate impact on affordability remains uncertain. However, these developments influence how mortgage risk is distributed and priced — particularly in the MBS market.

For advisors, a deeper understanding of agency and non-agency MBS can provide valuable context for client conversations and portfolio analysis, especially in environments where housing headlines and interest rate volatility intersect.

KEY TAKEAWAYS

- The U.S. housing market remains largely supply-constrained, with affordability challenges persisting despite policy efforts aimed at demand and supply.
- Policy initiatives can influence mortgage liquidity and pricing, but their long-term impact on housing availability remains uncertain.
- Mortgage-backed securities (MBS) span a wide spectrum — from agency MBS, which resemble government-related credit, to non-agency and Non-QM RMBS, which carry more direct housing and borrower risk.
- Understanding how different types of MBS function can help advisors better contextualize market headlines and portfolio behavior.

IMPORTANT DISCLOSURES

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