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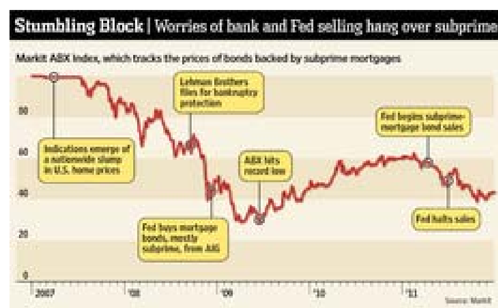
Investors Sour on Subprime Bonds

Money Managers Retreat From Market as Prices Decline and Upside Is Limited; 'Buy-and-Hold' Mentality

By AL YOON

After flickering to life early in 2011, the market for subprime- and other risky residential-mortgage bonds has returned to its comatose state. And many investors believe a revival could be years away.

Prices on some bonds, which are backed by mortgages that don't meet the standards needed to get backing from government-controlled companies like Fannie Mae and Freddie Mac, plummeted as much as 30% last year. The ABX, an index that tracks the value of subprime bonds, ended the year at 43.44 cents on the dollar, down from 59.90 cents at year-end 2010 and a peak of 62.68 cents in February 2011.



Associated Press

While that decline pushed yields up to as much as 17%—bond yields rise as prices fall—many fund managers have pulled out of the market due to worries about further price declines. Moreover, repeated downgrades have left too few investment-grade securities for them to own. Wall Street banks, which traditionally have played a key role in the market matching buyers and sellers, are backing away ahead of new regulations that will make it more expensive to hold riskier assets.

On top of that, European banks and the Federal Reserve still are holding billions of dollars of subprime-mortgage bonds, and investors worry they could flood the market at any time.

Investors are skeptical they can make a profit in the private mortgage market, which are loans not backed by Fannie or Freddie, said Marina Tukhin, head of mortgage and asset-backed trading at broker-dealer Gleacher Descap. This market includes bonds backed by subprime mortgages, which are given to people with poor credit; Alt-A mortgages, which are given to borrowers with decent credit who didn't meet other standard requirements to qualify for a loan backed by Fannie or Freddie; and "jumbo" mortgages, which are too large to get a government guarantee.

Less than 15% of the private mortgage bonds rated by Moody's Investors Service still carry an investment-grade rating, Baa3 or higher, compared with 53% of commercial-mortgage securities.

Without bank participation, confidence wanes, Ms. Tukhin said. "Once that confidence disappears, it doesn't really matter what the fundamentals are, and the fundamentals are not that strong, either."

Some investors had hoped the market was on its way to recovery. After crashing in 2008, as borrowers defaulted on mortgages, the market had risen slowly before rallying strongly in late 2010 and early 2011. By February

2011, the ABX was more than twice the levels of mid-2009. But the renaissance was short-lived.

Some investors blamed the Federal Reserve for snuffing out the rally. Seeing rising demand for the bonds, the Federal Reserve Bank of New York began shedding some of the $30 billion in mortgage bonds it took on as part of its 2008 bailout of American International Group Inc. But buyers quickly retreated and the Fed stopped selling.

Leading up to the Fed sales, "the market felt like there was price upside, and hedge funds and other active managers participated more frequently," said John Sim, a strategist at J.P. Morgan Chase & Co. "Now, the market is more for buy-and-hold investors who realize that price action to the upside is likely to be very limited."

The price slump has attracted buyers, some of whom anticipate a rally once Europe resolves its sovereign-debt woes. Jeffrey Gundlach, founder of DoubleLine Capital LP; his former employer TCW Group Inc.; Smith Breeden Associates Inc.; and Two Harbors Investment Corp. said they have been buying.

"It's a sector that has been undeniably cheap, but you have to have a longer-term investment horizon because, like any distressed market, it could get cheaper before it outperforms," said Bill Roth, co-chief investment officer at Two Harbors, a real-estate investment trust.

But some investors and analysts worry about an overhang of potential sales. The Fed is holding $20 billion of bonds and European banks own $100 billion, Nomura Securities estimated.

"People think the European debt crisis is going to lead to a tsunami of debt sales, and no one in a mark-to-market position wants to get ahead of that," said Daniel Nigro, founder of Warfield Consultants, a firm focused on mortgage- and other asset-backed securities.

Paul Norris, head of structured products at Dwight Asset Management, with $44 billion under management, has been selling mortgage bonds since March. He is worried that banks have become unwilling to help investors easily get in and out of trades, known as providing liquidity. He sold his subprime debt and recently shed bonds backed by jumbo mortgages that had "any chance" of losing their investment-grade rating.

Without liquidity, "you're in a no-man's land," Mr. Norris said.

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