Invesco

Strategy Insights | Fixed Income

What are US Agency CMBS?

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Overview

- IFI believes an Agency CMBS strategy can help diversify an overall fixed income portfolio.
- Like Agency RMBS, Agency CMBS carry a US government or government agency guarantee of principal and interest.
- Unlike Agency RMBS, Agency CMBS provide a level of prepayment protection, which reduces potential cash flow variability.
- Agency CMBS offer attractive return potential and have outperformed comparable asset classes in recent years.

US Agency commercial mortgage-backed securities (Agency CMBS) are bonds collateralized by pools of real estate loans secured by multi-family or health care properties. They are issued by a US government agency or federally chartered corporation, such as Fannie Mae, Freddie Mac or Ginnie Mae. They are a potentially attractive way, in our view, to access the US commercial real estate market.

Invesco Fixed Income (IFI) believes an Agency CMBS strategy can help diversify an overall fixed income portfolio by providing targeted exposure to multi-family or health care mortgage loans. Similar to Agency residential mortgage-backed securities (Agency RMBS), Agency CMBS benefit from a guarantee of principal and interest from the issuing agency or federally chartered corporation. However, they are typically less sensitive to interest rate risk for two reasons:

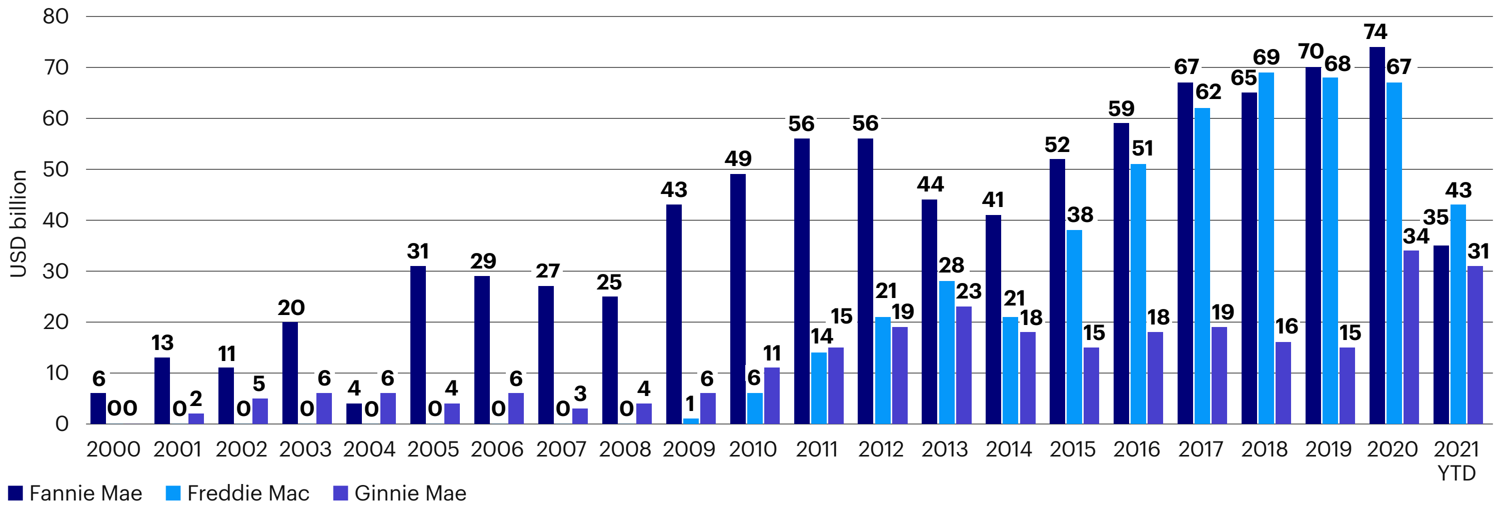
- Agency CMBS loans have balloon payments at maturity.
- Agency CMBS loans benefit from prepayment protection, which reduces potential cash flow variability.

We believe these features make Agency CMBS a potentially attractive complement to Agency RMBS in an overall portfolio.

Growth of the Agency CMBS market

Agency CMBS issuance has increased significantly since 2008. During the global financial crisis, US government agencies stepped in to fill the void created by private lenders who reduced loan originations as credit conditions tightened. After the crisis, government agencies maintained their efforts, especially to promote affordable housing, by expanding multi-family property lending. As shown in Figure 1, annual Agency CMBS issuance (by all three issuers) averaged approximately USD22 billion before the financial crisis. In 2020, annual issuance was approximately USD175 billion.

Figure 1: Agency CMBS Issuance Pre- And Post-Crisis



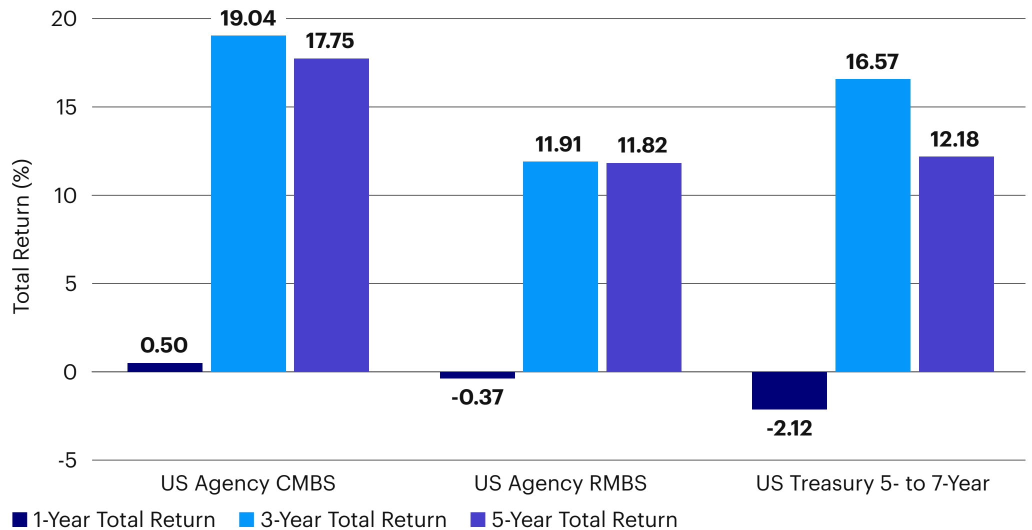
Source: IFI, BAML Research. Data from December 31, 2000 to July 31, 2021.

Why consider Agency CMBS?

Perhaps the biggest benefit of Agency CMBS is their guaranteed principal and interest payments backed by the issuing agencies. In this respect, Agency CMBS are similar to Agency residential mortgage-backed securities (RMBS), which carry the same US government or government agency guarantee. But unlike single family residential mortgages, which borrowers can often prepay at any time, multi-family and commercial mortgages typically limit borrowers' ability to prepay, providing a level of prepayment protection for Agency CMBS holders. In addition to prepayment penalties, other prepayment restrictions often exist on CMBS loans. This distinction gives Agency CMBS a more stable maturity profile, meaning there is less risk that the life of the bond will be shortened or extended.

Agency CMBS also offer attractive return potential. As shown in Figure 2, Agency CMBS have outperformed comparable asset classes in recent years.

Figure 2: Agency CMBS Have Provided Attractive Returns Compared to Agency RMBS and US Treasuries



Source: IFI and Bloomberg L.P. as of June 30, 2021. Indices: The Bloomberg Barclays US Agency CMBS Index; The Bloomberg Barclays US Mortgage-Backed Securities (MBS) Index; The Bloomberg Barclays US Treasury 5-7 Year Index. **Past performance does not predict future returns.**

Increased issuance and adoption have led to improved liquidity

Increased issuance in recent years has led to increased investor adoption and improved market liquidity. Agency CMBS have consequently grown as a percentage of the Bloomberg Barclays Aggregate Bond Index. Banks have been the largest investors, but money managers and insurance companies are active participants in the primary and secondary markets. According to data from the Securities Industry and Financial Markets Association (SIFMA), average daily trading volume increased from just under USD100 million in 2017 to over USD500 million in 2020.[1]

The amount of Agency CMBS outstanding currently totals around USD863 billion (Figure 3). Common programs include the Freddie Mac K-Series, the Fannie Mae Delegated Underwriting and Servicing program (DUS) and Ginnie Mae project loans (Figure 3). Figure 4 shows the percentage of Agency CMBS outstanding by issuer and coupon type: fixed, floating or hybrid.

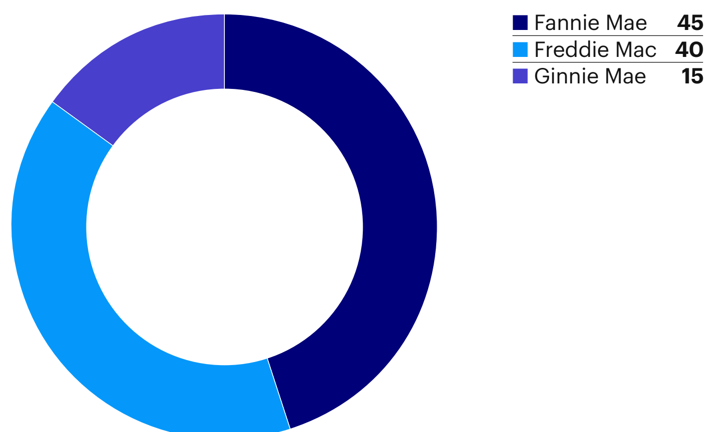
Figure 3: Summary of the Largest Agency CMBS Programs

Agency	Fannie Mae	Freddie Mac	Ginnie Mae
Program	**DUS**	**K-Series**	**Project Loans**
Outstanding (USD bn)	341	385	137
Guarantee	Timely interest and principal guarantee from GSE	Timely interest and ultimate principal guarantee from GSE	Full faith and credit guarantee by US government for timely interest and principal
Collateral	Multi-family properties, senior housing, student housing, manufactured housing and cooperative properties	Multi-family properties, student housing, senior housing, manufactured housing and workforce housing loans	Mortgages insured by the Federal Housing Administration
Loan Terms	5 to 30 years	5 to 10 years	10 to 40 years
Prepayment Protection	Yield maintenance, lock-out and prepayment premiums	Lock-out followed by defeasance	Lock-out followed by declining prepayment premium
Deal Structure	Pass-through or multi-class sequential pay classes	Multi-class sequential pay with non-guaranteed subordinate bonds	Multi-class sequential pay with simple or complex waterfalls
Typical Bond Weighted Average Lives	3 to 10 years	3 to 10 years	3 to 11 years
Rate Type	Largely fixed rate but some adjustable rate available	Largely fixed rate but some adjustable rate available	Fixed rate
Payment	Monthly	Monthly	Monthly

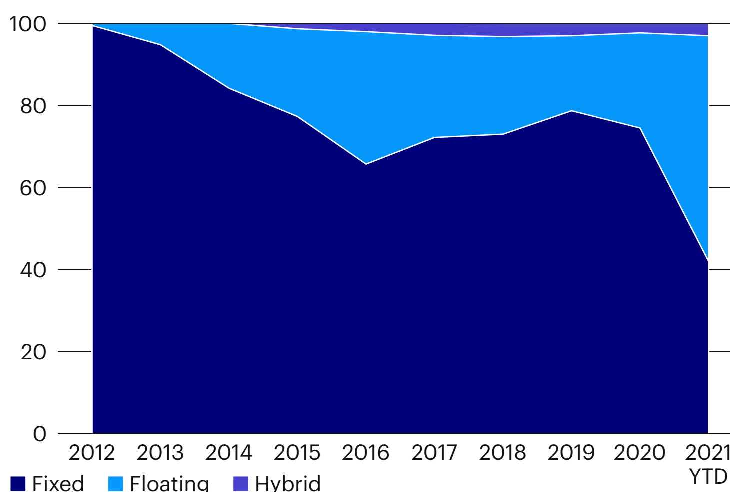
Source: IFI and JPM Research. Data as of July 31, 2021.

Figure 4: Agency CMBS Outstanding by Issuer and Coupon Type

Agency CMBS outstanding by issuer (%)



Agency CMBS outstanding by coupon type (%)



Source: IFI, BAML Research and Morgan Stanley Research. Data as of July 31, 2021.

IFI approach to CMBS

Invesco Fixed Income employs a balanced top-down, bottom-up risk allocation in our portfolio construction process. Our top-down analysis examines US macroeconomic and microeconomic factors, such as GDP growth, interest rates, labor market dynamics, consumer data and corporate earnings. We define fundamental trends in US commercial real estate, such as property supply, tenant demand, occupancy rates, rental rates and financing terms, to shape our outlook for various commercial real estate property types across geographic regions. Our outlook for each regional market and property type helps form key rent growth and valuation assumptions used in our bottom-up analysis, described below.

How IFI is different

While many investment managers rely on external credit ratings to make CMBS investment decisions, IFI conducts a review of each individual investment. Our analysis considers insights from IFI's Macro Research Team and Invesco's direct real estate investors, along with the views of US mortgage servicers and commercial real estate loan brokers. Our proprietary model projects loan level defaults and corresponding loss severities for the individual loans underlying each commercial mortgage-backed security (i.e., "collateral performance").

IFI conducts scenario analysis based on these collateral performance projections to project bond and transaction cash flows under various scenarios. We monitor collateral pool performance and make buy and sell decisions based on a relative value analysis of the investment universe. We believe our robust research capabilities and seasoned investment team allow us to identify attractive income opportunities and anticipate spread tightening, enabling timely sector allocation and careful security selection.

1. Source: SIFMA. Data as of December 31, 2017 and December 31, 2020.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Past performance is not a guide to future returns.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

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All data as of August 15, 2021, unless otherwise stated. All data is USD, unless otherwise stated.

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