eureka report

Investment Road Test: First Mac High Livez Income Fund

TONY RUMBLE | 19 DECEMBER 2011

PORTFOLIO POINT: The High Livez fund offers exposure to Australian residential property without the risks attached to specific properties.

With sharemarket returns continuing to be depowered by global deleveraging, and with frequent bouts of volatility-led price fluctuation giving additional heartache, investors need to think harder about how they can generate sufficient cash flow for retirement.

Term deposit rates are easing and will continue to do so as the Reserve Bank cuts rates over the next part of the cycle. As part of the growing investor backlash against the sharemarket, Australians are returning to the "safety" of bricks and mortar (read on as we discuss the merits and risks of property investing).

The leading independent Australian mortgage originator First Mac Limited has released a new fixed income fund giving exposure to mortgage backed bonds with the convenience of a managed fund.

The First Mac fund is called High Livez and presents as a well-designed and managed investment. Unlike some of the failed mortgage and property funds that litter the Australian GFC experience, High Livez doesn't invest directly in mortgages – instead it invests into the "residential mortgage backed securities" (RMBSs), which are issued by the securitisation vehicles that hold the mortgages directly.

RMBSs aze a well-known form of financial instrument, recognised as such by the Australian government, which provided liquidity to the RMBS market after the GFC to help that market remain open during the credit crisis.

To evaluate the merits of the High Livez fund we need to go on a short journey through the complexity of the mortgage securitisation industry. Please stay with us for this journey; despite the complexity, this is a thoroughly normal and orthodox part of the financial markets.

Securitisation in the residential mortgage market has been a feature of the Australian market since the 1980s and reflects the need for banks to manage their access to and cost of funding. Securitisation allows a bank (and non-bank lenders, like First Mac) to continue to originate and write residential mortgages, using specific purpose funding, which is then tied to the pool of mortgages created using that funding.

In fact the problem with the subprime mortgage failures (which led to the GFC) wasn't so much caused by the financial technology behind the collateralised debt obligation (CDO) funds that failed, it was at heart a problem with the quality of the underlying assets within those CDOs. For example, CDO funds that were backed by high-quality corporate or mortgage-backed securities were able to withstand the GFC – and even PIMCO (arguably the world's best bond fund manager) uses credit default swaps and derivatives when it invests.

The good news for prospective High Livez investors is that, if they are seeking exposure to the Australian residential property market, that is exactly what the fund invests in (as well as a small allocation to cash and bank deposits, mainly to provide liquidity for redemptions out of the fund). Specifically, the High Livez fund invests in the RMBSs issued by the mortgage securitisation vehicles associated with the First Mac residential property finance business, a highly successful and well-rated Australian business that has originated more than 60,000 and $10 billion of mortgages since inception in 2002, and has created more than $9 billion of RMBSs in respect of those mortgages since then.

RMBSs are bonds issued by the unit trusts that buy mortgages from originators including banks, and non-bank institutions like First Mac. Well-credentialed originators use highly transparent lending criteria and it's this, combined with the hard data regarding default histories for that specific loan originator's business, that allows for these unit trusts to get their RMBS rated by ratings agencies like S&P.

First Mac limits the "loan to value" ratio for its originated mortgages to no more than 80%, and has sound lending criteria in place (eg, it doesn't lend to borrowers with weak credit histories, all valuations have to be independently certified, all credit assessment is done by First Mac [not mortgage brokers], no development or construction loans are provided, etc). Full details are set out in the PDS for the High Livez fund and on its website. As a final precaution, all loans have independent mortgage insurance from reputable providers such as QBE.

●●●●

To understand how mortgage securitisation works, think about the difference between a first and second mortgage. First mortgages have first claim on all the assets and income of the underlying secured property, meaning that they rank ahead of claims by the second mortgagee. Because of that different risk, the first mortgage lender receives a lower rate of return than the second mortgage lender.

In the same way, RMBS unit trusts will create a series of bonds that have different priority and security against the fund's assets. RMBSs may create AAA-rated bonds that carry the highest ranking, down to A or even BBB-rated bonds (which rank after the claims of other bond holders). The process of creating different classes of securities out of a securitisation vehicle is known as "tranching" (the French word for "slice") and the concept of giving first claim over all of the assets of the fund to the highest ranking security holder is known as the "waterfall".

For example, consider an RMBS fund that holds mortgages over, say, $100 million of property and in turn creates, say, three classes of unit (rated AAA, A, and BBB) with the following criteria:

* $30 million of AAA-rated securities paying a margin of, say, the bank bill rate plus 100 basis points (1% pa).
* $30 million of A-rated securities paying a margin of, say, the bank bill rate plus 200 basis points (2% pa).
* $40 million of BBB-rated securities paying a margin of, say, the bank bill rate plus 300 basis points (3% pa).

This shows that the AAA-rated security has the first claim over the income and assets of the fund (and in return receives the lowest margin) and the BBB-rated security has the last claim over the income and assets of the fund (and in return receives the highest margin). The final item to note is that the underlying mortgages would need to have a default rate of over 70% before the AAA-rated investor suffered any loss. For good quality mortages in Australia, actual default rates are well below 5%.

The High Livez fund invests in RMBSs rated A or higher, with the majority of the RMBSs being rated AA-. So these aren't the highest ranking tranches of the RMBS programs, but nor are they the lowest.

Documents supplied by First Mac show that the actual arrears history on loans it has originated has been in the range of 0% pa to just over 3% pa, and actual defaults have been in the range of 0% to 9% since it began business. When and if a mortgagee defaults, the property is sold and the loan is repaid from the proceeds – and it is at this stage that mortgage insurance covers any loss.

First Mac data shows that there has been no actual loss to investors arising from any defaults on loans that it has originated.

So the real crux of the issue for potential investors in the High Livez fund is whether they want to be exposed to the Australian residential property market and, if so, whether the High Livez fund is an attractive vehicle for them to use to do so.

In fact it is the benefit of diversification that could be one of the main attractions for the High Livez fund. If "bricks and mortar" is to become the cure for investors shunning the sharemarket, it is vital not to be over-exposed to single properties and this is something which, for smaller investors, would normally be problematic. Using a fund that invests into high-quality RMBS with a good geographic spread will add value to most portfolios.

The First Mac business has survived the GFC and that is a massive positive in its favour. It is well capitalised and is itself rated "strong" by Standard & Poor's. The High Livez fund can invest in up to 75% of any specific RMBS issue created by First Mac (meaning that 25% of each issue must be placed to third-party investors – ensuring that the pricing and quality of each RMBS is effectively "verified" by those third parties).

With current returns to investors in the High Livez fund averaging around 8.36% pa (with a "target" return of 7.8% pa), and with income being paid monthly, the High Livez fund could provide a useful way for investors to access Australian property market returns without the risk attached to specific properties.

Using a fund like High Livez for just a small proportion of the overall portfolio should be an appropriate defence against future property market weakness. Fees are at the low level of 0.6% pa, which is good value for an investment of this sort.

The score: 3 stars

0.5 Ease of understanding/transparency
0.5 Fees
0.5 Performance/durability/volatility/relevance of underlying asset
1.0 Regulatory profile/risks
0.5 Innovation

Schroder Real Return Fund

In our recent review of the Schroder Real Return Fund we gave the fund 4 stars out of 5, with 0 allocated to the "Fees" section of our scorecard. In making this assessment we presumed that when the Schroder Real Return fund made investments into other Schroder funds, that fees were charged on both funds.

We now understand that the fees on underlying Schroder funds are reduced to 0% when the Real Return fund makes investments into them. Accordingly, we have recalculated the rating of the Schroder Real Return Fund as follows:

The (revised) score: 4.5 stars

1.0 Ease of understanding/transparency
0.5 Fees
1.0 Performance/durability/volatility/relevance of underlying asset
1.0 Regulatory profile/risks
1.0 Innovation

Tony Rumble is the founder of the ASX-listed products course LPAC Online. He provides asset consulting and financial product services with Alpha Invest but does not receive any benefit in relation to the product reviewed.