
From: Nav Gupta [REDACTED]
Sent: 2/3/2014 4:41:27 PM
To: Tazia Smith [REDACTED]
CC: Vinit Sahn [REDACTED]; Paul Morris [REDACTED]
Subject: Re: percentages get a read from your team [C]

Am not a mtge expert but read over the weekend that GS strat prefer po's over io's. Worth checking rv with the db io trader.

Mortgage Interest Only strips have become negatively convex

Lower coupon IOS (synthetic IO total return swap instruments) currently screen as having negative convexity, meaning that the downside risk from a rate rally is larger than the upside gains from a rate sell-off. On an option adjusted basis, the IOS appear expensive. Corresponding PO (principal only) securities, by comparison, have positive convexity and option adjusted spread, offering solid yields in a falling rate path in which principal is returned quickly due to prepayments.

We expect rising rates, but downside risks exist

While our central forecast is for interest rates to rise on the back of growth in the U.S. macro-economy, we acknowledge risks to the outlook, including uncertainty about the multiplier and the extent of private demand acceleration, as well as impacts from non-domestic shocks. Such sources of rates volatility should induce caution in taking on exposure to negatively convex positions.

Pricing of IO and PO is highly model dependent

Pricing of IO is highly sensitive to modeling assumptions – one of the reasons that IO typically price at very wide option adjusted spreads. A key assumption is the rate of housing turnover expected in a rising rise scenario. If floor prepa's are modeled as slow as 3 CPR, then IO do in fact offer meaningful upside potential, and PO substantial downside risk.

Either IOS or pass-throughs are mispriced

While it is possible to model IOS as fair, it is hard to model IO and pass-throughs as both fair, since a 3 CPR floor prepay assumption would imply that the pass-through has substantial extension risk and tight OAS. We would split the difference: we view IOS as moderately expensive and pass-throughs as slightly too tight vs. treasuries.

On 3 Feb 2014, at 18:19, "Tazia Smith" <[REDACTED]> wrote:

Classification: Confidential

Hello Vinit & Nav -

Paul and I spoke with JE this morning. This a proposal, from him, of putting ~100mm to work. I'm putting together some suggested tweaks on a few pieces (ex additional companies in japan, detail on the energy piece), and pricing, etc. Clearly always love your input as well Team! Please let me know if/when you have a moment to discuss, thanks! Also, recognize this is helpful in scaling ideas.

Best,
Tazia

----- Forwarded by Tazia Smith/db/[REDACTED] on 02/03/2014 01:14 PM -----