Jennison Associates
AI: Soft Power
Dmitri Rabin – Managing Director, Head of Structured Products
Stewart Foley, CFA – Insurance AUM.com

Audio starts

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. I'm Stewart Foley, I'll be your host. We are having as much fun with insurance asset management as the Illinois Insurance Department allows. And today's topic is securitized markets. And I'm thrilled about this because I've got a background here, and halfway, I think I might be able to hold my own for a minute. So we're joined today by Dmitri Rabin, who is the Head of Securitized at Jennison Associates. Dmitri, thanks so much for taking the time. We really appreciate you being on.

Dmitri: It's a pleasure.

Stewart: So, we're going to start this like we start them all. Where did you grow up, your hometown? What was your first job? Not the fancy one. And what makes insurance asset management so cool?

Dmitri: So as far as where I grew up, I moved, actually, from what was then the former Soviet Union, Minsk, now Belarus, when I was 12, and I moved to New London, Connecticut. And the interesting thing about New London as I settled in is, New London is right on the dividing line. On the one side is Red Sox Nation, and then the other side is all the evil people who cheer for the Yankees. And that part of Connecticut is right where the fracture point lies, and I made the right choice and moved to Boston after college.

Stewart: I love it.

Dmitri: So that's the background. I went to school here in Massachusetts and then settled here. But I've been here for all of the Red Sox and the Patriots championships, so we've been pretty spoiled.

Stewart: Wow, that's fantastic. And what was your first job?

Dmitri: My first job back there in Connecticut, I delivered newspapers pretty shortly after I arrived at the time when you still did that. But my first or semi-real job in high school was building computers. It was sort of the early nineties, and so there was this computer store not far from us, and they needed people who knew how to put stuff together and fix it and so on. And that was a lot of fun for the first job. Free internet, but very much in the middle already of the PC revolution.

Stewart: Wow. I remember that there were people who could build those things, and it obviously worked out for Michael Dell. But there were a lot of guys back then that built machines. I mean, you guys worked with insurance companies. In your mind, what do you think makes insurance asset management so cool?

Dmitri: I mean, the biggest advantage that insurance asset managers have is that they have long time horizons. In these markets, you always look for unfair advantages, and that's a huge unfair advantage where you can wait and invest when the opportunities are really there. We try to do that. We're able to do that because of the types of clients we have as a firm. It tends to be large, sophisticated, long-term client relationships. Also fairly long in terms of duration.

But knowing that you're sort of being evaluated over the long term allows you to do more interesting things in the markets and approach the markets differently than if you're thinking about week-to-week retail-type money.

Stewart: That's fantastic. So as I mentioned at the top of the show, thrilled to be talking about agency MBS, for example. So we've got a few questions to walk through here. And the first one goes, how has the agency MBS market performed year to date after what is obviously for everybody a very rough 2022?

Dmitri: So, we're recording this in the first week of October, and I say that because the markets have been changing very, very quickly. So if we think about 2022, that was a historically bad year for agency MBS. The Federal Reserve raised rates very quickly. And when we think about agency MBS, you're not taking a lot of credit risk. You have Fannie, Freddie, Ginny guaranteeing your securities. The risk you're taking primarily is duration volatility risk or convexity risk, that when rates go up, your bonds tend to extend and when rates come down, your bonds tend to short. Because the borrowers at the other end of those bonds have the ability to prepay. So 2022, the Fed raised rates very quickly, the mortgage market extended. And as it extended, it underperformed, treasuries having the second-worst year since we started keeping records in the eighties. The only year that was a little bit worse was 2008.

Stewart: How much extension did you see on an OAD basis?

Dmitri: It depends a little bit on the model you use. But if you look at the tights that you saw, mortgages were a year and a half in duration roughly in 2020, 2021 when the Federal Reserve was buying mortgages and everybody was refinancing into 2.5% or 2% mortgage. The market got very short. Today it's about six years. So you want from less than two years to six years duration. That's really extraordinary. We've seen that very, very rarely in the mortgage market.

It creates certain opportunities in that you end up with an asset that is longer, which is more attractive for insurance companies. It's also more attractive for many other buyers. And also an asset where your convexity risk is a lot lower. And the reason your convexity risk is lower is if you're fully extended, it's very difficult to extend once you get to a certain duration. The borrower who took out the Fannie 2.5% or Fannie 3% mortgage that now has a seven-year duration, the only prepayments that are going to come out of that is when somebody moves because they have to. You're not going to have a lot of refinancing. And so you're as extended as you can be, and that improves your convexity quite a bit.

Stewart: Yeah. I mean, it's interesting because my wife and I bought our house in October of '20, and I locked in a 2.85% 30-year fixed mortgage. And having a finance background, I politely said to my mortgage guy, who's phenomenal... I'll even give him a plug, it's Mike Nielsen, who pulled a rabbit out of his hat. And I'm like, "What's the most I can possibly borrow?" So mortgage models are based on assumptions. And people like me view my debt as an asset. It's like, why would I pay that down?
So how do you think about those mortgages that have already extended? How much like a bullet are they? Or in other words, I guess another way to say it is, is that extension risk properly priced?

Dmitri: We think that coming out of 2022, not only was it properly priced, it's pretty attractively priced. Because in addition to the extension, we also saw widening. And we saw widening for a couple of reasons. First, we saw widening as people adjusted their expectations. So it is sort of very close to full expectation. The market has now priced to long-term prepayment rate of 3% or 4%, which we refer to as turnover. That's just the normal rate at which people upgrade house or move or divorce or die. That's pretty much all you've got in there. And from there you have some upside that maybe prepayments will be a little bit faster, but you don't have a lot of additional extension downside.

At the same time, you're getting that spread over longer duration, and that's pretty attractive from our perspective when we look at it. And we do think that there's some opportunities for security selection within that. Not all of the mortgages will prepay at the same speed. There is geographic overlays, there's overlays in terms of credit and loan to value that we run, that allow us to get better prepayments. Because you might think about somebody like you who thinks about their mortgage as an asset, but somebody who takes out a mortgage and has a low FICO and has very limited borrowing, they may think of their mortgage more like of an ATM. That person might choose to refinance even into a higher rate in order to pay down credit card debt that is accruing at 20% or 30%.

So there are some opportunities for security selection, and when you think about a mortgage like yours, which was a 2.85% mortgage, it's probably packaged into a 2% coupon security. That's a mid-70s dollar price. So every time a borrower prepays, that's at 25 points of upside to the bond holder because the prepayment happens at par. So small changes in prepayments from our perspective are really, really important, and create in some ways a generational opportunity that we've really never seen to perform security selection and think about some of these securities.

Stewart: You think they'd let me pay off at 70 cents on the dollar? I think this is a good strategy. I got to get back on the phone with Mike. So you kind of referred, not directly, but you really are kind of referring to the coupon stack. So where are you looking today in the... First of all, here's a question from a guy that isn't in this market anymore. What's current coupon on October the 3rd? And what part of the coupon stack do you like and why?

Dmitri: So the coupon stack is the different mortgages that have been originated over time and were packaged in 50 basis point increments. So today the coupon stack starts at 2.5% mortgages. Those were typically 2%, 2.25%, 2.5% borrowers, and goes in 50 basis point increments to 2%, 2.5%, 3% and so on. And today, and it's difficult to believe it, but we're somewhere between a 6.5% and a 7% current coupon, which means that the borrowers are in the high 7s in terms of their actual rate. So that again, people have to go back to. We used to say, well, you could go back to 2005, but now we're even further back than that in terms of rates.

So when we look at opportunities for security selection, we're looking at all of those different coupons, from 1.5%, to now 7% is the highest that's being produced. And they're going to have very different characteristics in terms of prepayment rate, in terms of convexity, in terms of how volatile those prepayments are. The lower coupons are going to be the ones that are fully extended. Those are going to be your 2% coupon. Those borrowers, we know that they're not going to prepay. The 7% borrower, that's a very different situation. They could prepay if rates rally even a little bit from here. And we're a little bit more cautious around that market. Now, the market has been offering more spread, at least nominal spread, in the higher coupons near the current coupon. But we think that thinking about this in option adjusted terms, thinking about it adjusting for the probability that the borrower will prepay as rates move around, is the right way to think about that market. And we sort of move around a little bit.

Now, I'll give a couple of examples. If you go back two years, hard to believe it's been two years, the Federal Reserve was buying everything that was being produced, which at the time were 2%, 2.5%, and 3% mortgages. And spreads on those got to extremely tight levels and we found ourselves quite underweight because we just didn't see value at those levels, even versus treasuries. And at the same time as you went further up the stack, there were some opportunities where the Federal Reserve was not as involved. But overall we held less in our benchmark in terms of mortgages.

Fast-forward to 2023, the March of this year, the Federal Reserve had stopped buying so those lower coupon mortgages had widened and there was an opportunity. But then in March if you remember, we had several high-profile bank failures. Silicon Valley Bank, Signature, and First Republic. And the FDIC upon seizing the first two of those, found very large mortgage portfolios that they had to liquidate. And those mortgage portfolios were in those lower coupons. Well, that led to a pretty significant widening and that was a pretty unique opportunity from our perspective to buy some of those securities and cover some of those underweights versus the benchmark, because now they were priced much, much more attractively from our perspective than before.

And since then, spreads have been going up and down a little bit, until we got into late September and October. And as we sit here today, we've had a fairly historic selloff in the long end of the treasury market. Which again, if you're an insurance company, that's pretty cool because for the first time you get to buy long-dated securities generation at pretty wide spreads and yields. But it does mean that mortgages have underperformed more here with this latest backup and rates. And we're seeing new opportunities and thinking about the market, so refreshing our views, versus where we were two weeks or four weeks ago even, given these changes.

And we have the tools to be able to do that, to adjust the durations every day, to hedge in and to think, okay, at these new levels, what's the same and what's different?

Stewart: That's really helpful. So Jennison likes the ABS market. Why do you think the ABS market is attractive? And are there particular segments that you like and that you're avoiding? And I'll throw this one little tidbit on the end. I saw a headline the other day that credit card balances had gone sharply higher of late. Are you watching that? I'm sure you are. And what's your view of it?

Dmitri: Let me talk for a minute about how ABS and structured products in general fits into what we do. Jennison is pretty unique in terms of how we manage money. We tend to take less risk than our benchmark for a significant portion of the cycle, and hold significant reserves in the form of treasuries or other liquid securities, with the expectation that when we get into markets which are distressed, we can take very aggressive advantage of those opportunities. That was true in 2008, that was true in 2020 as the firm positioned itself.

What that means is that our task, when you think about ABS or agency mortgages, is to stay very high quality. Because we set for ourselves a very difficult goal. We are not outperforming by taking a lot of credit risk. We look to outperform while maintaining very high quality and liquidity, so that when we get into a difficult market, we're going to sell treasuries first, but at some point we're going to want to sell mortgages or ABS in order to buy 20, 30-year securities that have widened 2 or 300 basis points. Really completely different upside in terms of those trades. So that's the background for how we think about it. What that means is that in the ABS market, we're going to be involved with the AAA sector, and even there we're going to be mostly involved with the more benchmark sectors. That's going to be cards, autos, equipment, really high-quality stuff that's been tested through the 2008 cycle and some other cycles before instance.

To answer your question about ABS, first about the fundamentals and the credit. Yes, credit card balances are going up. Some borrowers are starting to borrow more. But I'm pretty sanguine based on the data that I look at, and I look at a lot of data, about the performance of the US consumer. Because that same US consumer has created tremendous wealth in the stock market, and most importantly in the housing market. House prices are up a significant amount post-Covid, and a lot of that wealth is available to the consumers.

Well, we sort of see a world of two consumers. We see a prime consumer which tends to have higher employment stability, higher income, and tends to own their house with a fixed rate mortgage. Those consumers in terms of both their income and their balance sheet are in a very good position. The subprime consumer, broadly defined, are going to be folks where the income stability is lower, the overall income is lower, and they tend to rent. That consumer is where we see already quite a bit of weakness. And we're going to be far more cautious in terms of where we operate in the subprime model market or in some of the more off-the-run sectors of consumer lending than we are in the benchmark, high-quality, prime auto sector.

So at that AAA level, I feel entirely comfortable, but even as I look at the overall credit of that consumer, it's very, very good. I'll give you an anecdote for one of the reasons why. After '08, banks tightened credit standards in ABS because a lot of people had gotten burned. And after 2000, they tightened them even more. And over the last two years we have been in an environment where we've had a shortage of cars. So when you think about new car credit and you look at FICO scores and credit scores, they're as high as they've ever been. And the reason is that if you come into a dealer and you say, "I need a car." They're not the ones working to sell you a car. You're the one working to buy that car. And in that environment where there's a shortage of iron, and the same applies to equipment and so on, no dealer, no lender is going to stretch to get a borrower that's on the margin. They're going to go with the best borrowers. And the resulting quality of what we're seeing is just very, very good.

At the same time, you've asked about value. We actually see a lot of value in the ABS market and spreads are relatively wide. And the reason for that we think is that if you look at the ABS market, banks were a large part of the buyer base. And banks have not been buyers over the last year and a half. Some of those issues have been well publicized. The same is true of mortgages. So when we compare ABS to corporate credit where the buyers are mostly money managers, insurance, and others, and banks have not been as active, ABS looks quite attractive. And I'll give a pretty specific example. We've seen high-quality industrials, think Toyota, John Deere, firms like that, issue a AAA ABS paper at wider spreads and where they're unsecured trades. So issuing a AAA paper, you're getting paid more to be secure to be AAA than you would to a A or triple BBB industrial.

And to us, those are opportunities that are pretty unique. The way that we are set up as a firm is the credit, the rates, the structured PMs and traders, all sit together. We work together very closely. We manage the portfolios together. And we're rewarded based on how the overall portfolio does, not the sector. That's really important because when we see those opportunities, we can take advantage of them right away. It's as quick as having a conversation with a person sitting at the desk next to you across the aisle about, "What are you seeing? This is what I'm seeing. How much is stuff widening?" And you could react in terms of buying and selling very, very quickly.

But the upshot of it is, we see ABS fundamentals in the prime high-quality market to be very good. We see spreads which are historically in the 80th or 90th percentile, so wider than they've been over the last 10 years 80% or 90% of the time, and much wider than what we're seeing in absolute relative terms in the corporate credit market. And so to the degree to which we have needs in that short two to three-year part of the curve, we're going to be overweight ABS here. Taking spread while maintaining liquidity, not taking a lot of interest rate risk, so your relatively short duration, and not taking a lot of credit risk. That to us is a pretty interesting and unique opportunity at this market.

Stewart: So you mentioned the banks, and I want to turn our attention a little bit to CRE. So what's your view on CRE and the potential implication for banks? And then if you would, can you work in some comments on the CMBS market?

Dmitri: So we're concerned about commercial real estate market and the CMBS market for two reasons. The first reason is there's been disruption in cash flows in the commercial real estate market. None of us are working as much in the office. Leases are getting dropped. Occupancy is declining. Now, most leases are pretty long, but as they come due, buildings are not going to be as full. And some of those issues show up in the other parts of the commercial real estate market as well.

The second one is very familiar to insurance buyers, and that's interest rates. If you borrowed against the building at a 4% cap rate, and now that cap rate is 8% and the buildings are long duration assets, the value of the building has declined significantly. And next time you have to refinance, you have to refinance at a much lower valuation, and either put in money or walk away, because you're not going to be able to borrow the same as you had before. And we are seeing those issues realized.

When we look at the commercial real estate market, we're staying in either agency guaranteed paper, or at the AAA conduit level almost exclusively. And even there we're finding 1 out of 5, 1 out of 10 deals to be a drag. It's very different than where we were a couple of years ago when we did own, it's 10-year paper, it's AAA. It can be attractive at certain points in the cycle, can replace corporates, can do other things for you. But right now we have more concerns, and we don't see valuations as being that attractive.

Stewart: Yeah, it makes sense. And so even though Jennison doesn't invest in CLOs, do you have an opinion on that market? Insurance companies are very big buyers of CLOs as you know, and I'd love to hear your thoughts from there as well.

Dmitri: Yeah, we choose not to invest in the CLO market and maybe someday the value will be there when we look at fundamentals and risks. But there's a couple of reasons for why. The first reason is that CLOs are repackaged, low-grade secured corporate debt. And that debt is floating rate into a higher rate environment. We have some fundamental concerns, and this is not just me but also our corporate PMs. We have some fundamental concerns how that underlying corporate debt is going to perform, and what it means for the CLO structure that has bought it.

It's very different when you have LIBOR plus 300 debt and LIBOR is 0 or SOFR is 0 effectively, instead of SOFR 5%. Okay, well your cost of funding has instantly gone from 3% to 8%. That's not straightforward and that's happening before you get any kind of a recession or any kind of economic stress. So that's the first.

The second reason is that it doesn't get us the liquidity or the diversity that we look for. And what I mean by that is when we're buying ABS, and particularly if we're buying mortgages, we're buying an asset that's not highly correlated to corporates. So in an environment where corporates widen, mortgages might widen, they might not. They will certainly historically have widened less into those types of environments when we look at it historically. There's an opportunity to rotate sectors, and sector rotation is a big part of our strategy. If you're buying CLOs, you're buying corporate debt, just in a different structure. And that sector is going to perform very much in line with corporates. So it doesn't give us a diversification.

It also only goes out to about 5 years. When we do get overweight corporates, the opportunity to buy very high-quality companies at 10, 20, 30-year duration, is something that we like, something that our clients like, and something that should be close to the heart of insurance companies when it's just those opportunities only come around every 3 to 5 years. And we're lucky enough to have a sort of client base that has the patience for us to take advantage of them fully.

Stewart: That's great. You know what, I've loved every minute of this. This market's so important. It's a huge part of the public securities market, and it's one that I haven't managed actively for a minute or two, but it's great to get back in and go through it. And I really appreciate you giving us the education on your sector.

Before we go, I've got a couple of fun questions for you. And you can take either or both. Most of people take both, but there's no pressure. First is, what is the best piece of advice you've ever gotten? And the second is, who would you most like to have lunch with, alive or dead?

Dmitri: Do you know what, those are wonderful questions. I'll start with the second. So as far as somebody to have lunch with alive or dead, I love books, and to me, based on everything that I've read, I'm super interested in William Shakespeare; have been in a long time. Not just because of the great literature he produced, but because of his total commitment to his craft. The way that he operated and continued to refine throughout his life all of his works, while also directing and doing all the things that he did. I guess I respect people who work really hard and get results out of that. So that to me, he operated the theater, he was a partner in the businesses that he worked in. It's really, really interesting to me.

As far as the best advice I've ever gotten, be humble. In any particular situation, you're going to not know a lot more stuff than you do know. And the corollary to that is, always seek out people who are really, really smart to learn from. Look for them in this market. That means look for them in your counterparties. Look for them in the people that you hire or that hire you. That's super important.

Stewart: Dmitri, what's interesting about the William Shakespeare thing is when I taught, there was a gentleman there who was a Shakespeare expert. And he did a lunch and learn on three sentences out of three different Shakespeare plays. And I was on the edge of my seat. This has been 10 years ago. He said there's a book a day written about William Shakespeare still. Which is amazing.

Dmitri: It's really, it's not just literature which I enjoy, but actually when you read about how much revision and how much continuous work went into the creative process, it's pretty extraordinary.

Stewart: That's fantastic. Is there a particularly interesting hobby that you have outside of work that you enjoy?

Dmitri: Yeah. In terms of the unusual things that I do that people find surprising, probably the most surprising, I've been part of a board of a hospital clown troop now for 15 years. And that's an organization here in Boston and the surrounding towns where we train people, volunteers and paid clowns, that go into primarily pediatric settings, hospital settings, and spend time with kids. And I started out on the board, eventually became chair, and actually at the end of this year I'm retiring after 15 years on the board. So it's bittersweet.

But if you think about the sort of folks who have the emotional bandwidth to go and do that work, it's a really extraordinary group of people. And what I bring to that organization is a skillset around structure, no pun intended, fundraising, and really thinking about how to organize everything to make it as easy as possible for them to do what they do. And it's been incredibly rewarding.

Stewart: That's fantastic. I love that story. That's fantastic. Congratulations on 15 years of amazing success. I didn't know such a thing existed. That is so cool. I've gotten a great education and I learned something new, so thanks for being on, Dmitri. We really appreciate it and we've learned a lot.

Dmitri: Stewart, very nice to meet you and thank you for having me on.

Stewart: My pleasure. We've been joined by Dmitri Rabin, Head of Securitized at Jennison Associates. Thanks for listening. If you like us, please rate us, review us on Apple Podcast, Spotify, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.Logo: Jennison Associates

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