

Shape of the Markets

HEADS THEY WIN, TAILS YOU LOSE

SEPTEMBER 2026

There was a recent news article that spoke about the risk inherent in mortgage bonds, or Mortgage-Backed Securities (MBS). Finally! A well-read news source produced an article we actually agree with, and one that speaks to a major reason we have historically carried an underweight to the sector.

The article is about the negative convexity found in MBS. As a reminder, negative convexity is the result of the underlying optionality found in home loans.

- If rates fall, the underlying loans will refinance, resulting in these bonds being called away: *it appreciates like a short bond when you want a long bond.*
- However, if rates rise, the underlying loans remain outstanding for longer as they refinance at a much slower pace. *It depreciates like a long bond when you want a short bond.*
- You will often hear our team refer to this as “heads they win, tails you lose.”

This cash flow volatility is a real risk that is often overlooked and mispriced within fixed income, as witnessed by the vast exposure to MBS in the Bloomberg US Aggregate Bond Index (the “Agg”) and amongst our peers.

One argument against this train of thought is that spreads compensate investors for this cash flow volatility, and therefore investors can look past the negative convexity with confidence. However, in our experience, these spreads have been inadequate to compensate for the negative convexity inherent in these bonds, and today’s spread levels are no exception.

If there is little volatility and rates trade within a tight range, MBS will indeed be more competitive with other sectors. However, it is when we experience rate volatility that the risk of owning MBS becomes impossible to ignore.

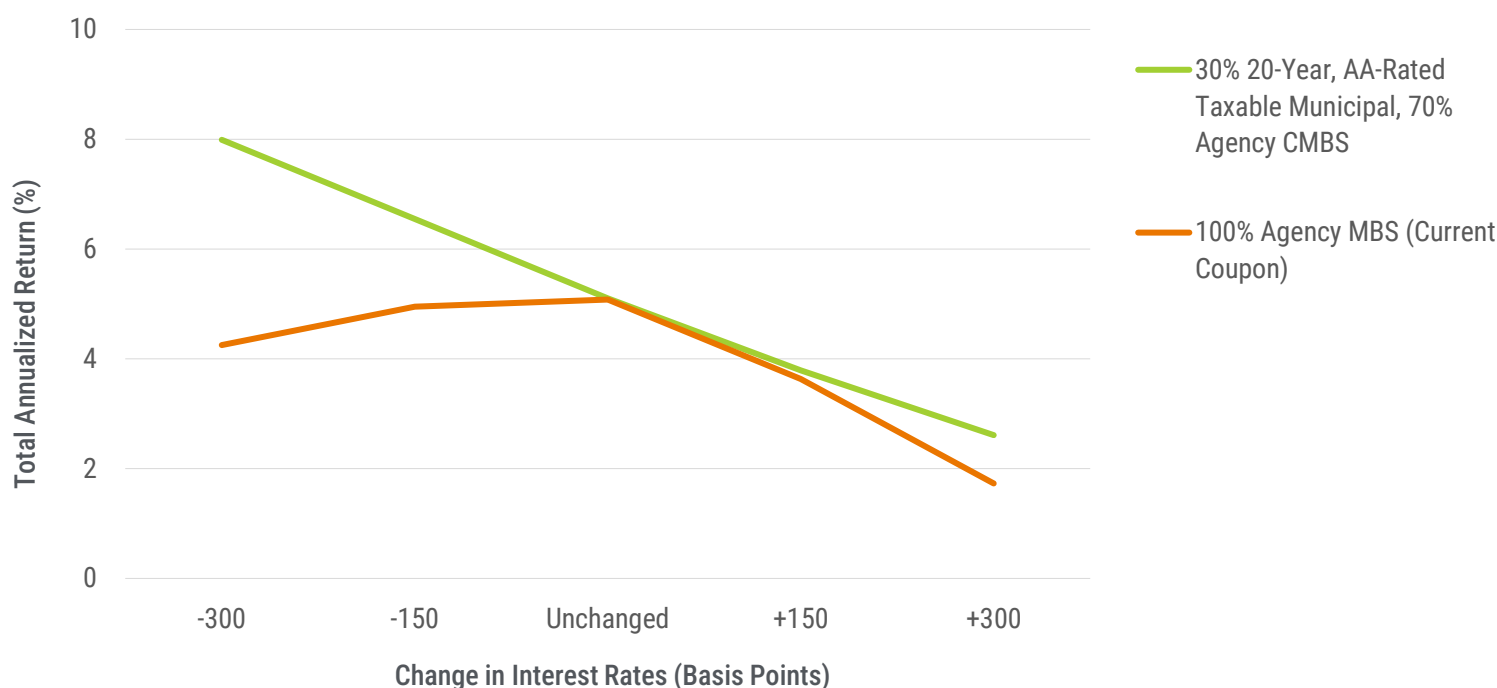


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Three-year horizon total return analysis (Illustrative performance)



For illustrative purposes only. Not indicative of future results. Sources: PTAM, Bloomberg, Intex, Yieldbook, Blackrock Anser, Interactive Data Pricing and Reference Data LLC as of 8/31/2026. We have generated Agency MBS to compare sectors the Firm invests in since it represents one of the largest sectors of the Bloomberg US Aggregate Bond Index. For MBS, we selected a generic MBS pool with similar coupon and loan age to new issue MBS pools. These total returns are estimated over a 3-year horizon. To create the Agency CMBS, and the 20-Year AA Taxable Muni, we take all the holdings in our portfolio that fall into those buckets and then create a weighted average (weight determined by position size) total return for each sector. The following bonds that are used to create the Shapes are held by PTAM clients as of the date of this presentation: Agency CMBS and 20-Year AA Taxable Muni.

Assumptions: (1) a parallel shift in the yield curve (2) static allocation for 3 years (3) linear rate changes (4) sector specific spreads are held constant across five rate scenarios (5) reinvestment rate consistent with respective sector.

If interest rates are unchanged over the next 3 years, new issue Agency MBS will roughly “tie” a combination of 30% 20-year Taxable Municipals and 70% Agency Commercial Mortgage-Backed Securities (CMBS). It is in this rates-unchanged scenario that MBS presents its best potential performance on a relative and absolute basis. **Put differently, in our view, MBS is essentially a bet on no rate volatility.**

However, MBS is a great illustration of the potential benefit of viewing bonds like a motion picture (like with Shape Management) instead of a snapshot in time (like with yield and spread). In scenarios where interest rates rise or fall, the potential outperformance over MBS is easily witnessed. As the magnitude of a potential interest rate movement increases, so too does the potential for outperformance.

As we’ve seen time and time again with MBS products, in an environment with rate or spread volatility, what you see is not what you get. The reason for this is **negative convexity, which can only be a detractor from your total return as rates move either higher or lower.** The current yield and spread advertised by MBS are an investor’s absolute best-case scenario, and as the article states, mortgage bonds are at risk if rates rise – and if they fall.

Risks and Other Important Considerations

Investing involves risk; principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in asset-backed and mortgage-backed securities include risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. For a complete list of disclosures, please visit www.ptam.com.

When selecting a bond to invest in, most investors rely on what we refer to as “traditional fixed income metrics,” which are generally a combination of (1) taking a stance on whether interest rates will increase or decrease, (2) yield and (3) duration. Nearly 30 years ago, PTAM’s founders recognized the potential shortcomings in traditional bond metrics, and developed Shape Management, a math-based investment process that addresses each of these shortcomings by analyzing the risk return profile of a bond’s future cash flows. Shape Management is a mathematical calculation that analyzes the risk return profile of a bond’s or group of bonds’ future cash flows. By using Shape Management, PTAM creates projections of the performance of specific bonds or grouping of bonds. These projections are not the actual performance of any bond or product. As a result, Shape Management performance in this email were not actually achieved by any PTAM investment or product. The criteria and assumptions underlying the projected performance may prove to be incorrect. Prospective investors should not rely solely on such projected performance and should conduct a thorough independent analysis of the investment opportunity. The graphs included throughout this email are provided for illustrative and educational purposes only. Projected performance results may have many inherent limitations. No representation is being made that an investment will, or is likely to, achieve profits or losses similar to those shown. In fact, there are frequently significant differences between projected performance results and actual results subsequently achieved. Although projected performance may be useful to consider when making an investment decision. Investment decisions based on Shape Management information may not be profitable. All projected performance is shown as net performance, which includes management fees, reinvestment of interest payments, principal payments, and capital gains.

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