

## Bond Managers Handling the Subprime Mess with Finesse

These fixed-income chiefs have exercised prudence and may profit from a recovery.

### Fund Spy

by Paul Herbert, CFA

In the process of gathering information about the state of affairs for subprime asset-backed securities in recent weeks, we have spent a fair amount of time interviewing fund managers with positions in these bonds. (As a reminder, asset-backed securities are bonds backed by groups of financial assets, such as certain kinds of home loans. Their creditworthiness usually depends on the performance of these underlying assets.) We were able to learn more about a few managers who had developed an understanding of the risks involved early on.

Below are managers who have navigated these conditions well—but it's not a complete list. There are plenty of other good managers—among the big firms who run Fund Analyst Picks this would include managers at FPA, T. Rowe Price, Vanguard, to name just a few—who are doing well in this tough environment. But it's a good bet that the managers listed below will be in a better position to pick up quality securities on the cheap when they have determined that the worst is over or nearly over.

### Metropolitan West

The team at Metropolitan West Asset Management, which runs Analyst Pick Metropolitan West Total Return Bond (MWTRX), has been cautious on the subprime situation since at least 2004. At that time, it started writing to its clients about the growing market dependent upon mortgage lenders relaxing their standards and borrowers who were stretching beyond their means. Met West also warned that there could be potential losses for bondholders when the housing market slowed and interest rates rose.

The team's caution helped it focus on the better originators and to stay away from a lot of the loans issued in 2006, when underwriting standards really began to weaken. The Met West team has also been paying very close attention to bonds' structures. Asset-backed are split up into groups according to ratings, and one of the team's strategies has been to focus on the highest-rated classes (or tranches) of subprime ABS, for two reasons. First, as borrowers repay their loans, the tier rated AAA gets paid first. Second, when borrowers default, losses hit the unrated and lowest-rated (usually referred to as "subordinated") portions before those above them, and are unlikely in many cases to affect the portion of the deal rated AAA at all. Met West has also held lower-rated classes issued in 2004 and 2005, after determining that their prices don't reflect the fact that there is ample subordination left below, cushioning them from losses. These moves have helped Total Return to sail into the intermediate-bond group's best 5% so far in 2007.

Portfolio manager Bryan Whalen, who heads up Met West's asset-backed and mortgage-backed securities group, said last month that he viewed the recent weakness in subprime ABS as a buying opportunity, but that he wasn't "backing up the truck" because of pricing difficulties.

### PIMCO

The housing market has been at the center of PIMCO's economic outlook in recent years, so it's no surprise that the firm has spent a lot of time analyzing prospects of the subprime ABS market and the various ways to capitalize on its volatility. Scott Simon, head of the firm's mortgage-backed and ABS teams and portfolio manager of PIMCO Mortgage Backed Securities (PTRIX), started calling in March 2005 for a top in home prices. His call may have been early for a while, but in 2007 he, and PIMCO for that matter, have appeared to be right.

It also isn't unexpected given PIMCO's comfort with derivatives that the firm has used derivatives contracts rather than bonds to express its bearish view on the subprime market. The Mortgage Backed Securities fund has been long credit-default swaps, which are instruments structured to pay off for their holders when negative events such as defaults take place. Simon expects that taking that position added about 20 to 30 basis points (or 0.20% to 0.30%) of performance for the fund, which has been torching its intermediate-term government peers in 2007.

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### Fund spy (cont'd)

Simon, whose input on mortgages informs the work of diversified portfolio managers at PIMCO, including Bill Gross at Total Return (PTTRX), also said late last month that he wasn't diving back into the subprime ABS market, but that he was getting closer to investing.

### Western Asset

Though some of Western Asset Management's funds, including Analyst Pick Core (WATFX) and Core Plus (WACPX) have suffered because of some weakness in its corporate-bond holdings, the fixed-income behemoth has been pretty conservative on the subprime arena. Ron Mass, who leads the firm's structured products group, said in July that his firm has also stuck with higher-rated classes of subprime ABS, for much the same reason that Met West has. He further pointed out that even if defaults do touch the firm's AAA holdings, recovery rates will likely be relatively high given their senior positions. Mass also discussed sticking with shorter-dated securities as another defensive measure. A subprime loan's AAA class may be further divided into "timed tranches," that is, into smaller groups depending on when they will receive repayments. Western Asset has been sticking with these earlier cash-flow tiers because they get paid off before losses start to occur.

Western hadn't been buying into lower-rated securities at the time we talked to them, but Mass said he has been a buyer of attractively valued higher-rated fare with characteristics similar to those mentioned above.

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## Metropolitan West Total Return Bond Fund (MWTRX)

★★★★★ 5-Star Overall Morningstar Rating based on risk-adjusted returns as of 7/31/07 among 972 Intermediate-Term Bond Funds.

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The Metropolitan West Total Return Bond Fund (MWTRX) was ranked by Morningstar as of 7/31/07 based on total return within the Intermediate-Term Bond category. The fund received a percentile ranking of 3%, 2%, 2%, and 1% among 1102, 972, 806, and 409 funds for the one-, three-, five-, and ten-year periods respectively. Morningstar ranks funds from 1 (being the highest percentile rank) to 100 (the lowest percentile rank). A top performing fund will receive a rank of 1 in its category. Past performance is not indicative of future results.

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