Commentary

Commercial Mortgage-Backed Securities

By: SEI Investment Management Unit

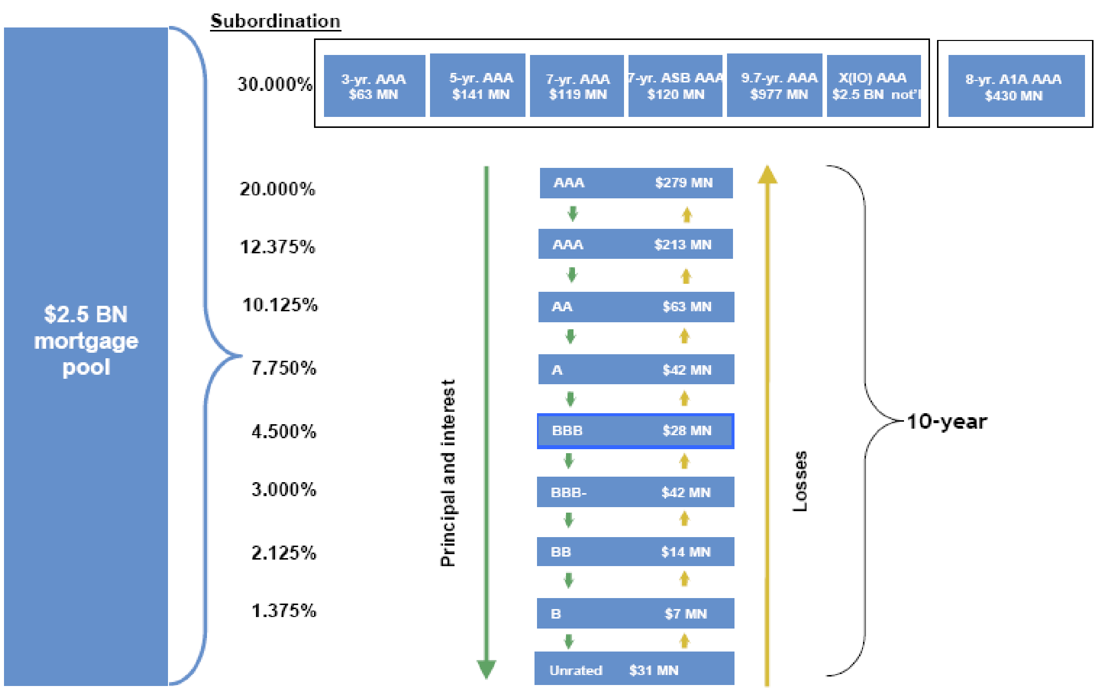
Overview and Market Update

Commercial mortgage backed securities (CMBS) have been and continue to be an integral part of some of SEI's fixed income strategies. Over the last several weeks, deteriorating credit fundamentals, confirmation of an economic recession, ongoing deleveraging and very limited liquidity conspired to inflict enormous downward pressure on prices of this market. Additionally, technical market conditions are punishing this sector as insurance companies and other traditional investors in this market are having issues of their own. Given these extraordinary events, a review of CMBS securities and an update on market conditions provides insight into why SEI remains confident in CMBS and the role they play in a diversified portfolio.

An Introduction to CMBS

Commercial Mortgage-backed Securities are securities that are collateralized by pools of geographically diverse loans on various types of commercial real estate properties, including office buildings, retail, warehouses, multi-family housing, hotels and health care properties. These properties are income producing and operated for economic profit. A typical commercial real estate loan that is used as collateral for these deals is a ten year fixed rate structure with a 30 year amortization schedule and a balloon payment due at maturity. The loan is generally originated for 80% of the value of the property (loan to value ratio) and incorporates features that require the borrower to maintain a minimum level of interest coverage. They also have very strong call protection on prepayments for several years preventing the borrower from refinancing due to lower interest rates.

The structure of a commercial mortgage backed security is very similar to the structure of a residential mortgage backed security. The principal and interest payments on the underlying loan collateral are passed through to the holders of each class or tranche of the CMBS based upon a priority of payment hierarchy determined upon issuance. Each tranche has varying levels of credit enhancement to protect against potential cash flow delays and shortfalls. This credit enhancement usually takes the form of support via the allocation of any loan losses to the securities at the bottom of the capital structure, starting with the unrated classes and working up the structure. This provides the required level of overcollateralization to the senior securities in the structure and, combined with the priority of interest and principal payments, results in an AAA rating from the rating agencies. As a result, the highest rated and better protected tranches trade at lower yield levels than the below investment grade classes.



Source: JPMorgan

The largest portion of a standard CMBS deal is the ten-year, AAA rated “super-senior” tranche, named as such because this AAA rated security has the most credit enhancement relative to other AAA rated tranches in the deal. These “super senior” securities are often used as the bellwether for the market, as they are typically the most liquid security in the deal. The CMBS allocations in the SEI Funds portfolios are predominantly comprised of these securities which typically have 30% credit enhancement to protect against loan losses.

Recent Results: A Market in Turmoil

In November 2008, the CMBS sector posted its worst month of performance on record, underperforming US duration equivalent Treasuries by nearly 23%. Investment grade CMBS spreads widened over 700 basis points to 1,541 basis points, bringing the market yield to about 15.50%, a historical record high, before retreating in the final week of the month to 1,085 over treasuries. Even spreads on AAA rated CMBS, at the senior most point of the capital structure, so called “super senior” bonds, likewise gapped wider and these securities are now yielding close to 14.00%. Current pricing at approximately $67 for these high quality securities is now reflecting wildly improbable assumptions regarding delinquency, default and loss severity even though the structural superiority these bonds provide substantial protection against capital losses.

The catalysts for this event include:

1) Widespread hedge fund, bank and broker dealer forced deleveraging

2) A shift in the focus of the Government’s TARP program away from mortgage related securities, including CMBS

3) A buyers strike by traditional investors (insurance companies and money managers)

4) Three retailer bankruptcies (Mervyn’s, Boscov’s and Circuit City), and the announcement by General Growth Properties, a levered REIT and large owner of retail properties, in its 10Q that it may struggle to continue as a going concern

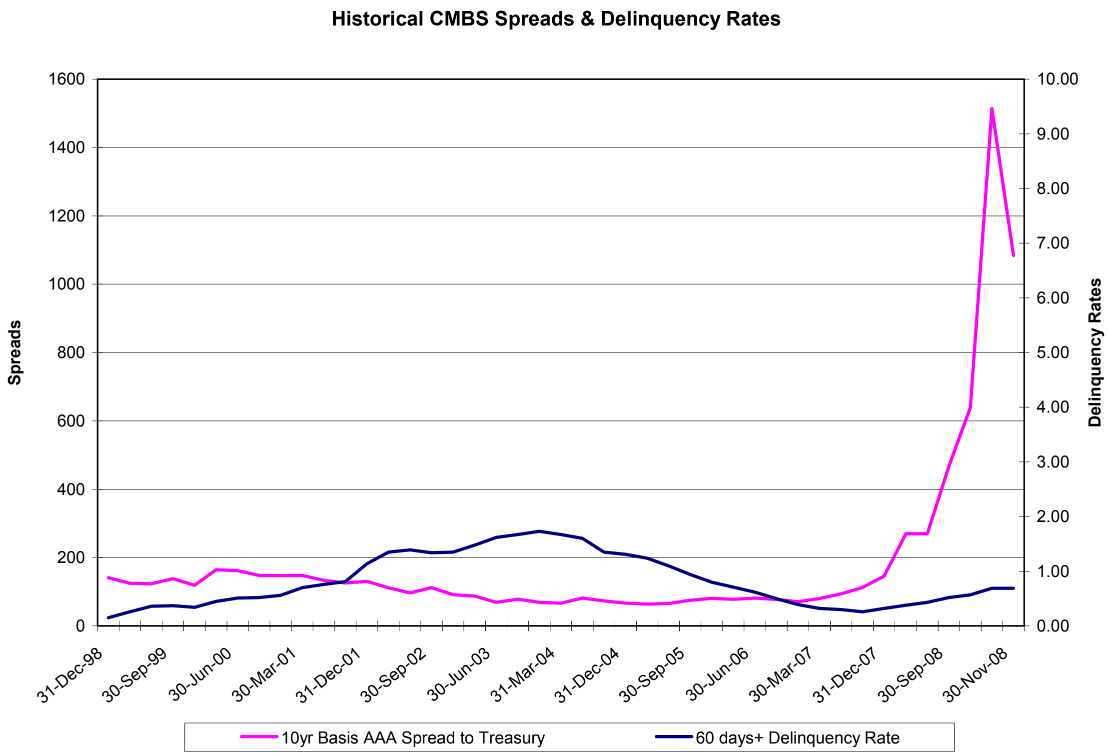
5) Downward revision of the US economic environment and its negative impact on the future outlook of the commercial real estate market

6) Overall sympathetic widening with other spread sectors like corporate credit

This confluence of horrible technical conditions and the expectation of a weakening of credit fundamentals has severely impacted market prices for even the highest rated securities in this sector. While the recent environment would not seem to encourage investors to participate in this sector, we suggest that to objectively evaluate CMBS, consideration must be given to underlying credit fundamentals and current market pricing to determine value.

What is priced in?

Current pricing on AAA rated CMBS is approximately $67, even as delinquencies remain benign. This has resulted in an enormous dislocation between CMBS yields and credit fundamentals as shown below.



Source: JP Morgan

While an increase in delinquencies and ultimately defaults is a logical expectation given market conditions, to properly evaluate the sector, investors must look at what assumptions are priced in. In November, AAA-rated ten-year senior CMBS securities traded near 70 cents on the dollar. As mentioned above, before a senior tranche of a CMBS deal experiences any impairment, the 30% of the deal represented by subordinated securities that provide protection for the AAA rated class must experience a total loss. This would suggest a default rate on 70% of the entire deal, and a loss severity rate of 43% (70% x43%=30%) on the value of the underlying collateral (loss severity rate) when the properties are liquidated. This compares with a historical ten year average cumulative default rate of 7.88%, according to a July 2007 report by credit ratings agency Fitch, and a historical average loss severity rate of 35%. [1] For a senior bond priced at today's current level of 70 cents on the dollar (a 30% discount on the principal amount), it would require a 100% default rate and a 49% loss severity rate before you have a loss on this discounted principal—an extraordinarily unlikely outcome. It should also be noted that these calculations simplify the actual default experience in this sector, where special servicers may extend the maturity of a loan or take other measures to maximize recovery.

A comprehensive study done by JP Morgan[2] comes to similar conclusions. Using their economic models and sophisticated data base on commercial real estate prices, default rates and recovery rates, they conclude that a deep recession, with worst case assumptions about default and property prices, would result in a 15% cumulative loss to a CMBS structure. As described earlier this would not come close to triggering losses in the senior AAA-rated securities. Given the current pricing of such securities, not only should principal be protected, but a significant yield and total return opportunity is available.

How this affects SEI Funds?

Many of SEI's fixed income funds and the portable alpha strategies used in the equity funds invest in CMBS. As such, the recent performance of these funds has been negatively impacted due to these allocations. It's important to note that the vast majority of the holdings in our funds consist of these AAA rated super senior tranches that have superior structural protection. Based on our managers' analysis of the underlying loans and the structure of these deals, the managers are confident that these securities represent tremendous fundamental and relative value based on today's prices.

---

[1] Bear Stearns US CMBS Primer – July, 2007

[2] JP Morgan CMBS Weekly Report – November 14, 2008

Conclusion

Over the last year, the performance of many sectors of the fixed income market has shocked investors as the credit crisis has evolved. At certain points it appeared that normalcy may be restored, only to have yield spreads hit new highs amid dysfunctional markets. The recent spread widening in the CMBS sector has been driven more by technical conditions rather than a real deterioration of credit fundamentals. That is not to say that the fundamental credit outlook for the commercial real estate sector is positive. SEI's and our managers anticipate that credit fundamentals will weaken and CMBS delinquencies, defaults and losses will trend higher. However, current pricing levels on CMBS super senior securities indicate that the loss assumptions priced into the market far exceed any plausible recovery scenario. In noting the dislocation between yield spreads and the underlying credit fundamentals, a unique investment opportunity can be identified. For investors who have a longer time horizon, and do not require near term liquidity, the spread sectors of the fixed income markets, including CMBS, offer a yield premium for providing such liquidity. While we can not predict an exact bottom in credit fundamentals, or the timing on a return to normalcy with regard to liquidity, we believe that patient investors will be rewarded.

On a final positive note, after initially dismissing the Government's participation in this market, the Treasury officials have stated that the TALF, which was introduced to finance and support the consumer asset backed securities market, may be expanded to include CMBS.

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts. There is no assurance as of the date of this material that the securities mentioned remain in or out of the SEI Funds.

SEI Investments Management Corporation (SIMC) is the adviser to the SEI Funds, which are distributed by SEI Investments Distribution Co. (SIDCo.) SIMC and SIDCo are wholly owned subsidiaries of SEI Investments Company. For those SEI Funds which employ the 'manager of managers' structure, SEI Investments Management Corporation has ultimate responsibility for the investment performance of the Fund due to its responsibility to oversee the sub-advisers and recommend their hiring, termination and replacement.

To determine if the Fund(s) are an appropriate investment for you, carefully consider the investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Fund's prospectus, which may be obtained by calling 1-800-DIAL-SEI. Read it carefully before investing.

There risks involved with investing, including possible loss of principal. Current and future portfolio holdings are subject to risks as well.

Bonds and bond funds generally decrease in value as interest rates rise. Mortgage-backed securities are subject to prepayment and extension risk and therefore react differently to changes in interest rates than other bonds. Small movements in interest rates may quickly and significantly reduce the value of certain mortgage-backed securities.

Index performance returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index. Past performance does not guarantee future results.
Bonds and bond funds will decrease in value as interest rates rise.

- *Not FDIC Insured*
- *No Bank Guarantee*
- *May Lose Value*