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EJF Investments Manager LLC
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Have You Hedged Inflation?

Arthur Wellesley, the 1st Duke of Wellington once observed, “The whole art of war consists of guessing at what is at the other side of the hill.” The same can be said for the art of investing.

The question in the market most being “guessed at” today is inflation. Are we experiencing the early signs of a lasting period of inflation? Or are we merely experiencing the transitory inflation asserted by US Federal Reserve Chair Jay Powell and other global central bankers? Although experts sit on both sides of the debate, no one can credibly argue that the signs of inflationary pressure are not present.[1] This past Friday, Chancellor Rishi Sunak proposed new rules to curb government borrowing, “amid fears that any rise in interest rates could blow a hole in the heavily indebted public finances.”[2] The proposed rules appear to be designed to address inflation, which rose 3.2% in August, the highest level since 2012.[3] In addition to reports of rising prices of consumer goods, UK citizens and companies are experiencing supply side disruptions and joltingly higher energy prices that will affect the prices of a broad range of goods from meat to steel. In the US, a similar set of inflationary data has been rolling in, with record high increases in August in both producer prices (8.3%) and consumer goods (5.3%).[4]

So what is at the other side of the hill? To be clear, EJF Investments Manager LLC (“EJF”), the external manager of EJF Investments Ltd. (LON: EJFI), chooses not to guess. But EJF would like to suggest to shareholders that if indeed inflation is looming over the horizon, EJFI’s current

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[1] See, for example, Jon Sindreu, “Transitory Inflation Can Be a Lasting Affair,” WSJ (September 20, 2021).
[2] George Parker, “New Fiscal Rules to Curb Borrowing and Bring Finances Back on Track,” Financial Times (September 17, 2021).
[3] Chris Giles, “Surge in Inflation to 9-year Hight Dents Trust in BoE Competence on Price Rises,” Financial Times (September 16, 2021).
[4] Randall W. Forsyth, “Soaring Producer Prices May Squeeze Profit Margins – and Stocks,” Barron’s (September 18, 2021).

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portfolio consists largely of short interest rate duration floating rate paper and Mortgage Servicing Rights ("MSRs").

At August 31, approximately 70% of EJFI's portfolio is invested in floating rate securities collateralized by the debt of small US banks and insurance companies. All else equal, if interest rates rise, the returns on this debt (called trust preferred securities, or TruPS) commensurately rises. As discussed more fully in EJFI's June 30, 2021 Interim Report,[5] we believe the credit quality of this paper is incredibly strong coming out of the pandemic shock of March 2020, with massive government stimuli directed at borrowers and the banks that lend them money. No bank or insurance floating rate instrument defaulted or suspended interest payments during or coming out of the pandemic period. In the US, Congress is gearing up this autumn to spend an additional $1T on an infrastructure bill and what we believe is an additional $2T in social welfare programs. These figures are on top of the $6T already infused in Covid-related relief bills.[6] The US government is certainly fanning the fires of inflation, and it stands to reason that banks will be among the leading beneficiaries.

Another growing part of the EJFI portfolio is invested in MSRs of US mortgages. MSRs represent the arrangement in which fees are paid to the holder in exchange for providing the administrative duties of servicing a mortgage loan, including collecting monthly payments, allocating principal and interest and managing insurance and property taxes. The negative interest rate convexity of MSRs is similar to the floating rate TruPs paper discussed above. Historically, rising interest rates have driven MSR values higher. The underlying fees paid to MSR holders come from pools of mortgages. The fees are based on the amount of debt outstanding in the pools, so the longer the mortgages in the pool remain outstanding the longer the MSR fee stream. When interest rates rise, mortgage prepayments and refinancing rates are reduced as the incentive to lock-in lower rates diminishes, which in return means a longer stream of fees for MSR investors. As a consequence, MSR valuations typically rise with the expectation of more secure and longer tenored income streams. In our estimation, MSRs are expected to further benefit in value from the tapering by the US Federal Reserve in the next quarter or two. The US Federal Reserve has been purchasing approximately $40B of mortgages per month which has had the effect of driving mortgage rates to historically low levels. Once the Federal Reserve reduces and eliminates its quantitative easing ("QE") purchases, we expect mortgage rates to rise from their historically low levels. Additionally, the credit quality of the MSR pools held by EJFI are extremely strong as they are newly issued Fannie Mae and Freddie Mac conforming. Currently the weighted average FICO score of the borrowers underlying EJFI's MSR portfolio is prime at 759, with LTVs of less than 68% and 60 day plus delinquencies less than 0.3%.

In our opinion, the EJFI portfolio is positioned to perform regardless of whether inflation is transitory or not. But it is extremely well positioned for a period of extended inflation. Although we are not asserting that inflation is "at the other side of the hill", we believe EJFI shareholders will be pleased with the portfolio's composition if it is. On top of this, as fiscal and monetary

[5] https://www.ejfi.com/media/1527/2021-09-10-ejfi-interim-report-rns-announcement-v2.pdf
[6] https://www.washingtonpost.com/business/2020/04/15/coronavirus-economy-6-trillion/

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stimuli make their way through the economy, EJFI's exposure to banks and insurance companies should benefit further as we believe the sector will continue to be one of the strongest beneficiaries of reflation.

If you would like to read more about EJF's positioning in light of inflationary signs, please read my colleague Peter Stage's recent interview in hedgeweek ("How EJF Capital is positioning for inflation as central bank moves recalibrate market dynamic", September 17, 2021).

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