Non-Agency

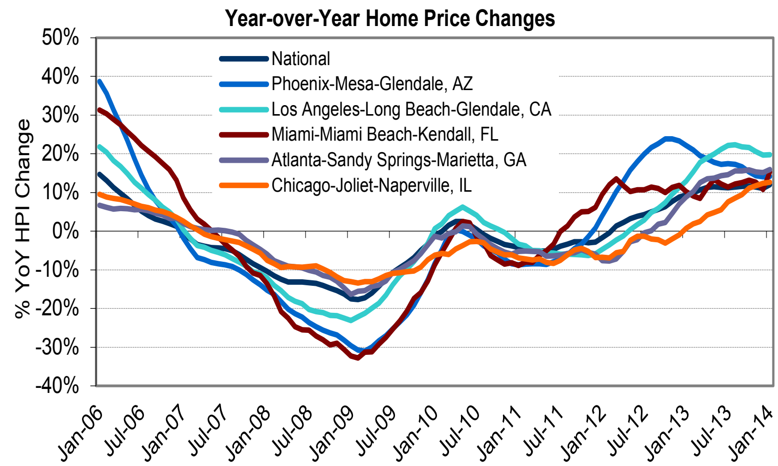
RMBS Trade Review

March 14, 2014

Market Review

Following a strong performance in 2013, prices in the U.S. housing markets continued an upward trend with CoreLogic National HPI increasing 12.02% Year-over-Year in January (Figure 1 - Home Price Index). Moderate improvements in employment and the overall economy led to continued improvement in first time homeowner delinquencies, foreclosures, and reduction of distressed properties available for sale. Tapering of the Federal Reserve's asset purchase program led to a back-up in mortgage rates which resulted in a slowdown in certain housing metrics. However, amidst the news of tapering and resulting volatility in the broader markets last summer, the Non-Agency RMBS market recovered and have remained resilient (Figure 2 - Market Prices).

Figure 1 - Home Price Index

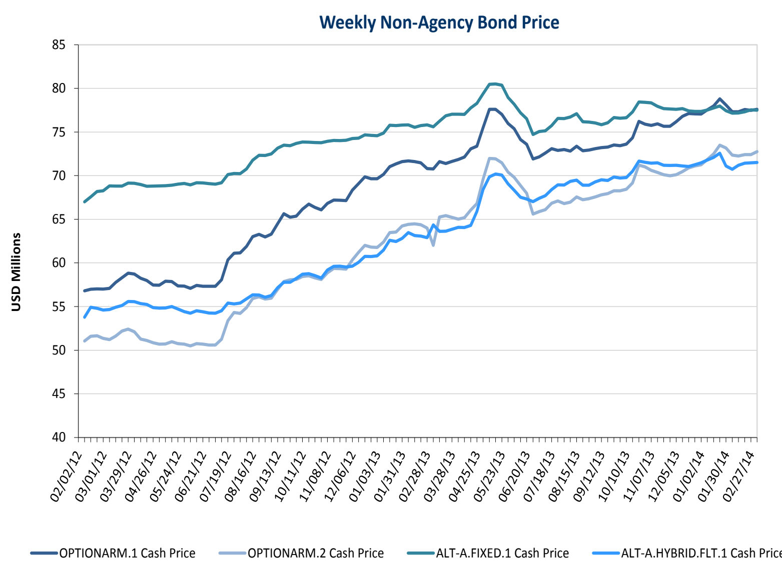


Source: CoreLogic, FBC

POA Sector Review & Trade Strategy

Pay Option ARM (POA) mortgages represent 12.9% of the outstanding $881mm Non-Agency market[1]. The majority of these loans have recast and are no longer eligible for negative amortization. They are essentially floating rate loans. We have been a strong proponent of this sector and believe, with a steepening of the credit curve, POA securities, especially those at the top of the capital structure, are well positioned for the continued recovery in housing and provide attractive risk-adjusted returns. **In this report we review a POA investment that combines the stability of a Super Senior cash flow with high credit support and a Senior Mezzanine bond from the same deal to create a blended investment offering risk adjusted returns superior to the each investment on a stand-alone basis.**

Figure 2 - Market Prices



Source: J.P. Morgan Markets, FBC

[1] J.P. Morgan Markets, FBC

Collateral / Structure (LXS 2005-5N)

Our sample trades (Figure 3 - Deal Overview) include two securities from LXS 2005-5N: 3A1A (Super Senior) and 3A2 (Senior Mezzanine). Both were originally rated AAA and receives its pro-rata share of principal from scheduled payments, liquidations, and voluntary prepayments. The collateral is negatively amortizing (although loans have already recasted), first-lien residential mortgages originated and or acquired by Lehman Brothers and Aurora Loan Servicing. We believe that Option ARM collateral will generally continue to outperform its peers for the following reasons: 1) minimal recast risk as the majority (over 90%) of the loans have already recasted, 2) limited modification risk to cash flows, relative to subprime, as principal reduction being observed is minimal across Servicers, 3) credit burnout trends continue i.e. the characteristics of the remaining pool continue to improve, 4) "HARP 3.0" and other programs that can lead to expansion of credit can increase voluntary prepayments in deals with large % of "Clean Current" borrowers, and 5) lower than projected "Tail Severities" due to increasing Short Sale liquidations vs. REO liquidations will result in higher recoveries on liquidated loans.

Figure 3 - Deal Overview

Tranche	CUSIP	Current Factor	Bond Type	Cash Flow Priority	Loss Priority	Orig Credit Support	Current Credit Support
3A1A	*86359DUR6*	*0.22*	*Super Senior*	*Pro-Rata*	Reverse Sequential	*40.00*	*33.70*
3A1B	86359DUS4	0.22	Super Senior	Pro-Rata	Reverse Sequential	40.00	33.70
3A2	*86359DUT2*	*0.22*	*Senior Mezz*	*Pro-Rata*	Reverse Sequential	*18.00*	*9.39*
3A3C	86359DUZ8	0.77	Senior First Loss	Pro-Rata	Reverse Sequential	9.50	0.00*

*All bonds below the 3A3C have been written-off due to losses.

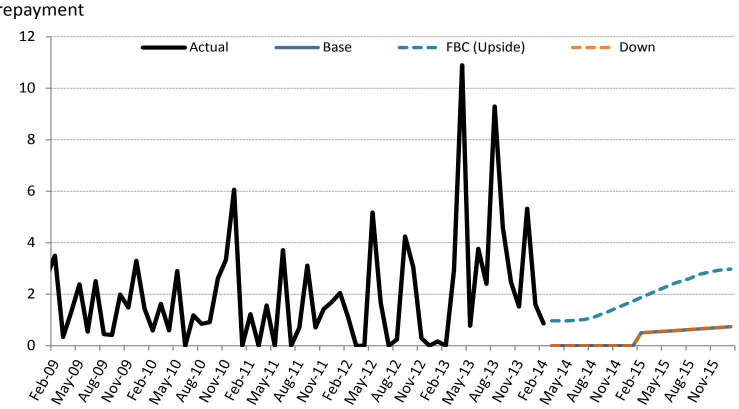
Collateral Characteristics[1]	
Average Balance	$347,705
Gross Coupon	2.95%
Loan Age	100
Current LTV	85%
Clean Current	29.2%
Total Current	69.6%
60+ Days Delinquent	22.6%
Negative Equity	23.0%
Modification	28.9%
Judicial State Exposure	31.7%

[1] Weighted Average except for Balance

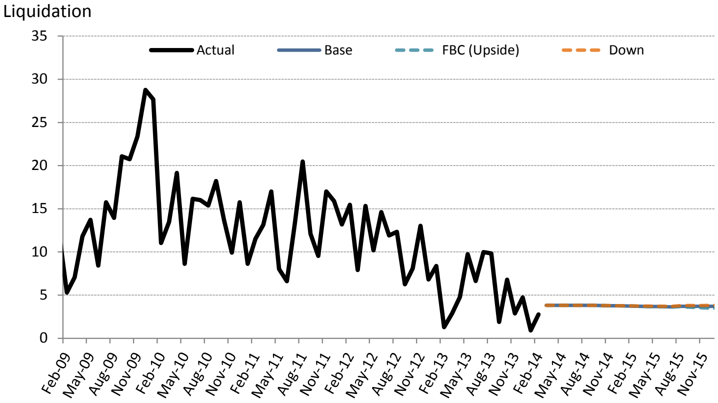
Assumptions

Using our proprietary loan-level models, we generate the following assumptions: Voluntary Prepay (CPR), Involuntary Prepay or Liquidation (CDR) and Loss Severity. We adjust our assumptions to account for servicing differences in modification recognition and recapture.

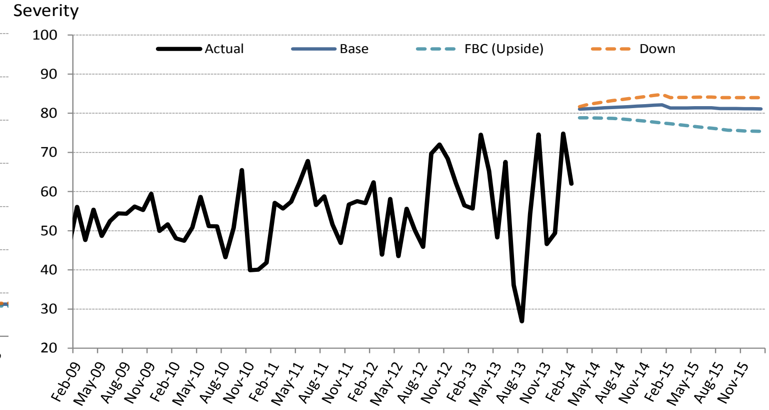
Prepayment



Liquidation



Severity



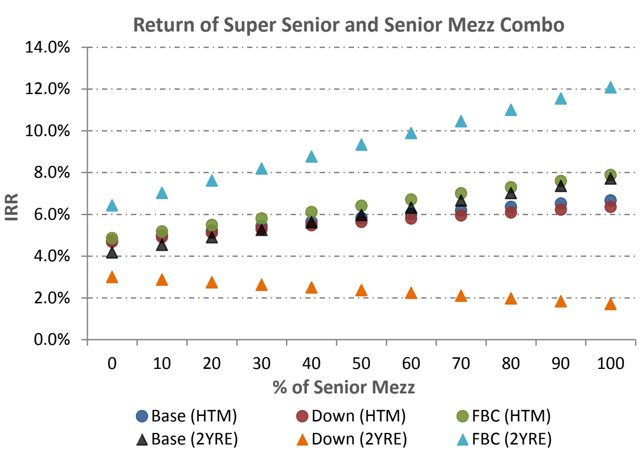
Trade Analysis

Our favorable outlook of POA loans can be attributed to the aforementioned underlying collateral characteristics and performances. We believe upside opportunities exist lower in the capital structure when we are able to identify higher quality collateral and bonds. The 3A1A is a Super Senior certificate with 33.70% credit enhancement and is supported by the Senior Mezzanine (3A2), subordinate (3A3C) tranches and overcollateralization (excess spread). As of 01/31/2014 the deal has an updated LTV 85%, 69.6% current loans, 22.58% 60+ delinquencies and 29% clean current. The collateral has outperformed even our most optimistic assumptions: prepayments were as high as 11% CPR over the past 12 months, liquidations have steadily declined with improvements in the current to 30 days delinquent rolls and loss severities have been averaging ~65%.

We priced the 3A1A at $87 and 3A2 at $70. The bonds were run under 3 different collateral assumption scenarios (Base, Down, and FBC) at held-to-maturity ("HTM") and 2-year exit horizons. At exit, depending on the scenarios, we tighten the spreads/discount margins under Base and FBC scenarios and widen the spreads/discount margins under Down scenario. The 3A1A is a very stable bond with consistent returns across all scenarios. The 3A2 yields are also stable under the HTM scenarios, but can be volatile under stressed assumptions. In order to take advantage of the high quality collateral and to mitigate the wide dispersion of returns, we created an investment comprising both the 3A1A (60% to 40% allocation) and the 3A2 (40% to 60% allocation) bonds. For example, changing the allocation from 100% 3A1A to 40%/60% 3A1A/3A2, the combination trade increases the return from 6.43% to 9.90% under the FBC 2-year exit scenario (Figure 4 - Return Attribution). We believe that asset selection will continue to be a central theme in 2014. For collateral and bonds with similar profile as LXS 2005-5N, an investment to include lower parts of the capital structure can better position the investor for an upside recovery in housing while minimizing the downside risks.

Occasionally, bonds with similar underlying collateral profile yet from two different deals can also be combined together to create a "Synthetic Credit Enhancement Structure" that enhances the blended risk-return profile of an allocation to Non-Agency RMBS securities.

Figure 4 - Return Attribution



Super Senior	Senior Mezz	Combined Metrics							
3A1A	3A2	Price	Base (HTM)	Down (HTM)	FBC (HTM)	Base (2YRE)	Down (2YRE)	FBC (2YRE)	Curr CE
100	0	$87.00	4.74%	4.69%	4.86%	4.18%	3.00%	6.43%	33.70
90	10	$84.94	4.99%	4.91%	5.18%	4.54%	2.87%	7.03%	31.27
80	20	$82.97	5.22%	5.11%	5.49%	4.90%	2.75%	7.61%	28.84
70	30	$81.09	5.43%	5.30%	5.80%	5.26%	2.62%	8.19%	26.41
60	40	$79.30	5.64%	5.47%	6.11%	5.61%	2.49%	8.77%	23.98
50	50	$77.58	5.83%	5.64%	6.41%	5.97%	2.37%	9.33%	21.55
40	60	$75.94	6.01%	5.80%	6.71%	6.32%	2.24%	9.90%	19.11
30	70	$74.36	6.19%	5.95%	7.00%	6.67%	2.11%	10.45%	16.68
20	80	$72.85	6.35%	6.09%	7.30%	7.02%	1.97%	11.00%	14.25
10	90	$71.40	6.51%	6.22%	7.59%	7.36%	1.84%	11.55%	11.82
0	100	$70.00	6.67%	6.35%	7.88%	7.71%	1.70%	12.09%	9.39

Note: 2YE assumes a sale in 2 years. Exit prices are determined by the composition of the collateral, its performance and the remaining bond credit support at exit.

The underlying loan data is provided by CoreLogic (subscription-based data repository) for a specific subset of loans. Our access to CoreLogic data includes approximately 95% of all U.S. Option ARM, Subprime, and Alt-A securitized product. Unless specified, Prime, Jumbo, or Agency Backed loans are not includes in the graphs and charts.

Algorithms and analysis to access the information and any interpretation are proprietary to Falcon Bridge Capital, LLC.

For questions or additional information, please contact:

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