Stormfield Capital

STORMFIELD INSIGHTS

Interest Rate Sensitivity & Private Mortgages

JUNE **2025**

Stormfield Capital

Many of our best ideas for white papers come from questions asked by clients, and this paper is no different. Not surprisingly, a question we are asked quite frequently in this environment is what degree of sensitivity our portfolio has to changes in interest rates. The short answer is very little. But as with many things, there is nuance to the answer that deserves exploration.

Firstly, let us remind readers that our loans feature original maturities of 6, 12, 18 or 24 months, with over 95% of our loans being of the 12 month variety.

Our loans also feature relatively high interest rates, generally in the realm of 9 to 12%. Taken together, these two features alone (i.e., short duration and high coupons), would lead one to mathematically expect minimal interest rate sensitivity (or duration in finance-speak) for the portfolio. When one performs a statistical analysis of our longest lived fund – the Stormfield Real Estate Income Fund, that expectation is confirmed, with the Fund showing no statistically significant sensitivity to SOFR, the U.S. 2-Year or the U.S. 10-Year Treasury.

FIGURE 1: REGRESSION ANALYSIS SREIF, LP & SOFR

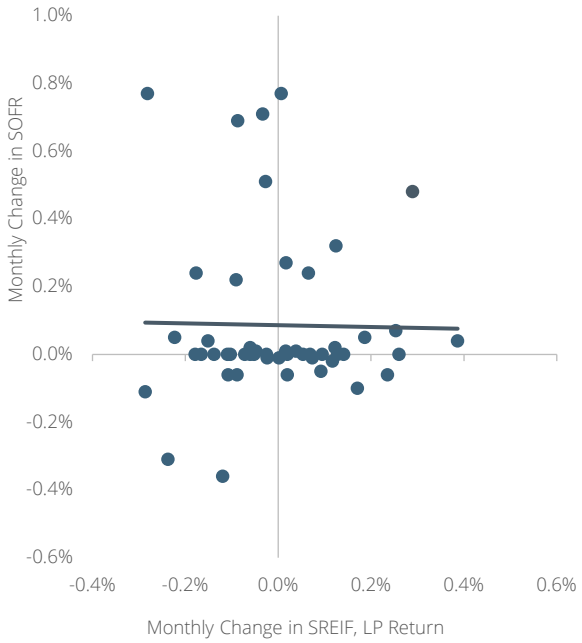


FIGURE 2: REGRESSION ANALYSIS SREIF, LP & U.S. 2-YEAR TREASURY

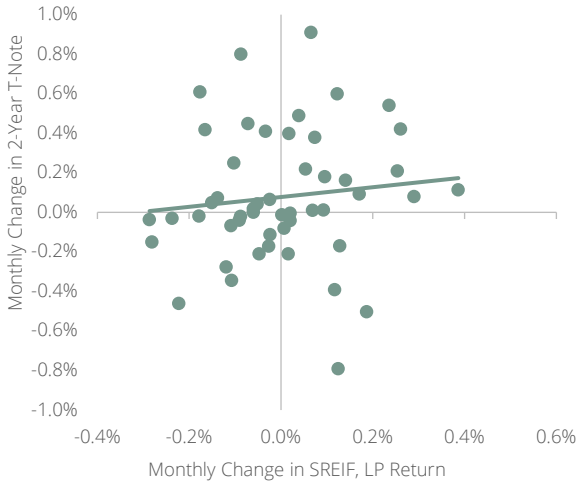
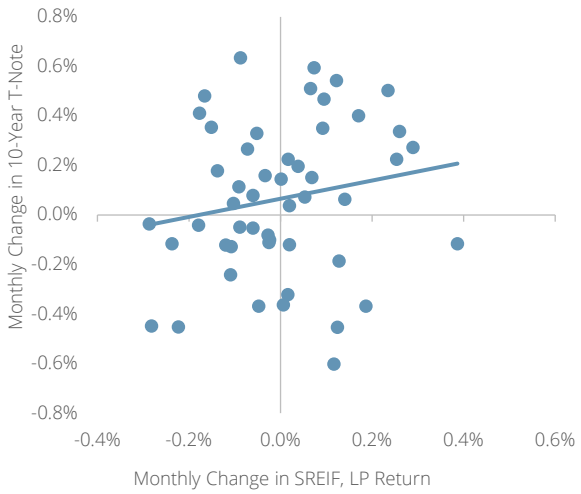


FIGURE 3: REGRESSION ANALYSIS SREIF, LP & U.S. 10-YEAR TREASURY



Sources: FRED, Board of Governors of the Federal Reserve System (US), Stormfield Capital

We can examine this another way, however, by looking at the average rate at which we have originated loans over the past several years to see if eliminating the accounting noise caused by a fund structure gets us a different picture. As one can see below, the same conclusion is reached – movements in SOFR, the U.S. 2-Year and the U.S. 10-Year have held no explanatory power over the rates at which we lend[1].

FIGURE 4: REGRESSION ANALYSIS FIRM & SOFR

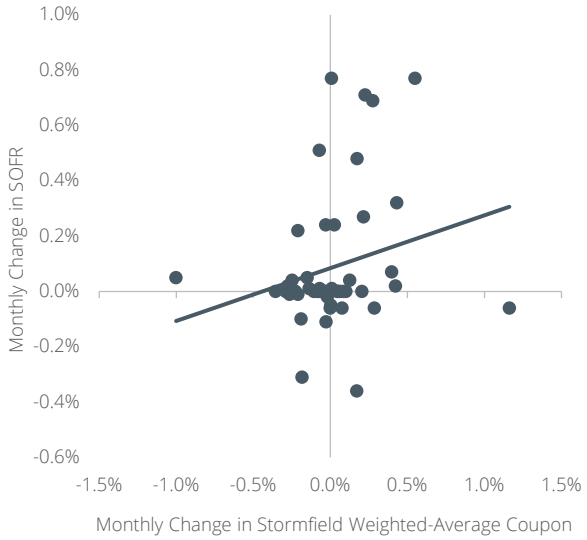
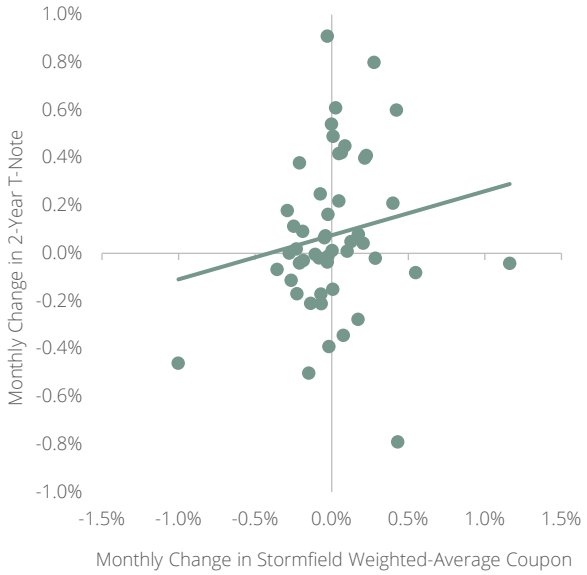


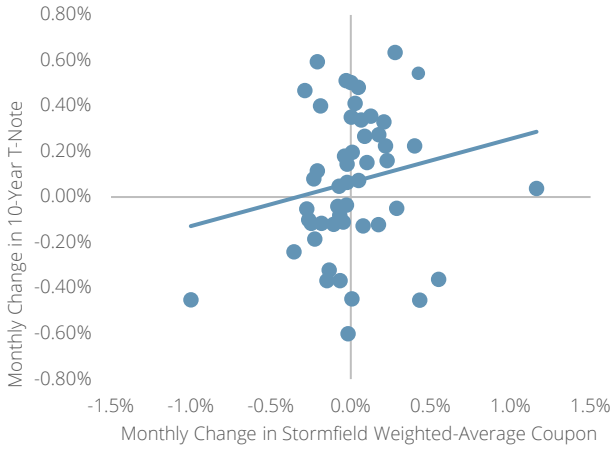
FIGURE 5: REGRESSION ANALYSIS FIRM & U.S. 2-YEAR TREASURY



[1]Neither the independent variables nor the regression as a whole pass tests of statistical significance.

Sources: FRED, Board of Governors of the Federal Reserve System (US), Stormfield Capital

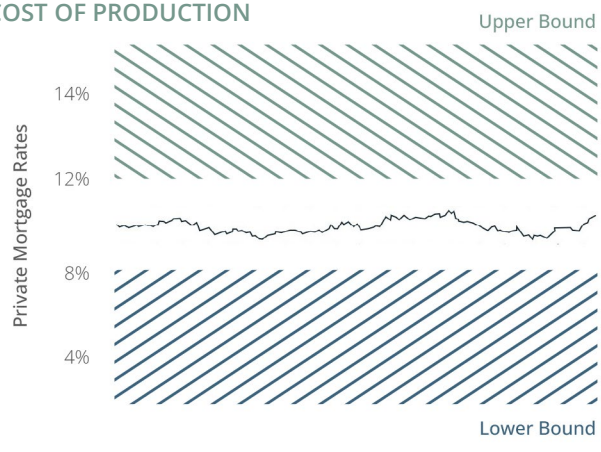
FIGURE 6: REGRESSION ANALYSIS FIRM & U.S. 10-YEAR TREASURY



We now reach the point where the aforementioned nuance comes into play. As Mark Twain famously quipped, "There are three kinds of lies: Lies, Damned Lies and Statistics." There are a number of issues with the fancy statistical charts above. Firstly, as must always be remembered, they are backward looking. Just because something had no relationship in the past does not mean it will continue to have no influence in the future. Secondly, the number of data points is relatively limited, weakening any statistical analysis. Thirdly, much of the analytical period occurred during a period of zero-bound short-term interest rates – a regime we are unlikely to revisit anytime soon.

So, what do we think the *future* will hold for the relationship between the rates at which we lend and the prevailing interest rates at the short and long end of the curve? The illustration below may help frame our thoughts.

FIGURE 7: COST OF PRODUCTION



What the illustration above attempts to demonstrate are the governing dynamics that rule over the rates at which we can lend. The "lower bound" is established by the cost of capital. Two fairly powerful forces to converge to establish this bound. Firstly, investors are not very excited to invest in private mortgages below this level, choking off the supply of capital to originate loans at lower levels. Secondly, originators, bankers and managers of funds are not very excited to deploy capital below these levels as the economics derived from their efforts become increasingly squeezed.

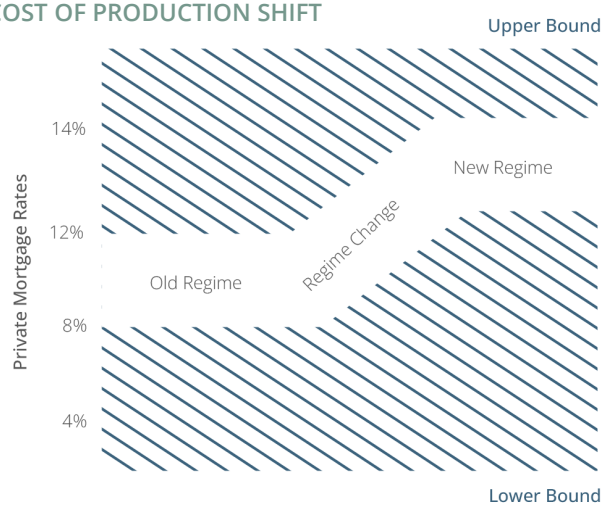
The "upper bound" is established by a different constituency – the sponsors looking to borrow. At a certain point, excessively high interest rates, even when applied for a relatively short period of time, break the mathematics supporting an investment, thereby choking off demand for new loans. There exists, however, a corrective solution for this interest rate ceiling – lower property values. Indeed, while private mortgage lending was barely a cottage industry in the 1970s and 1980s when structurally higher interest rates prevailed, rates on private mortgages were higher, often significantly so.

This leads to another nuanced layer of the question of how interest rates influence the portfolio. As we have discussed above, the first order impact is virtually zero. However, the second derivative impact – the influence on underlying real estate values – certainly does exist. All else equal, higher interest rates (and by higher, we mean materially higher than we are currently experiencing - a regime more akin to that seen in the '70s and '80s) would eventually lead to lower real estate values. Fortunately, this reset would most likely unfold over a prolonged period of time – likely several years. This highlights another hidden strength of our strategy, the short-term nature of our loans which enables us to continually reset our loan-to-value ("LTV") ratios to current market conditions as existing loans mature.

Put simply, were property values to drift down in response to higher rates, the interest rates at which we lend would increase whilst our estimates of the "V" in LTV would be regularly updated to incorporate diminished values in order to keep our LTV ratios within our conservative guidelines.

Indeed, in a higher interest rate regime we would expect the illustration above to shift to a materially higher channel of interest rates as depicted in Figure 8.

FIGURE 8:
COST OF PRODUCTION SHIFT



When one bundles this together, we see that a fund of properly underwritten, short term private mortgages can exhibit an uncommon feature: elements of positive convexity to an upside regime change in the level of interest rates – a rare feature amongst mortgages, which generally feature negative convexity in response to both increases and decreases in interest rates. Stated more directly, there exists a floor beneath which rates are unlikely to fall, but scenarios in which higher interest rates eventually flow through to the interest rates at which we lend – acting as a hedge to the long-ago interest rate regime of the 1970's and '80s.

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1. Sources: FRED, Board of Governors of the Federal Reserve System (US), Census, Longtermtrends
2. Sources: FRED, Board of Governors of the Federal Reserve System (US), MSCI, CoStar, Conti Capital, NCREIF, FRB