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MORTGAGE-BACKED SECURITIES

Fixed Income: Mortgage-backed Securities

You want the steady stream of income that bonds can provide. What are the possibilities? If you want to enhance your income and enjoy lower investment risk, consider the advantages of mortgage-backed securities.

WHAT ARE MORTGAGE-BACKED SECURITIES?

There are two types of mortgage-backed securities (MBS): pass-through pools and collateralized mortgage obligations (CMOs).

When you invest in mortgage-backed securities, you help lower the cost of financing a home and make housing more affordable for many Americans. In exchange, you receive monthly payments of interest and principal as homeowners pay off their mortgage loans.

PASS-THROUGH POOLS

Pass-through pools are mortgage securities backed by mortgage loans. They are called pass-throughs because the mortgage payments each homeowner pays "passes through" the issuer to investors. The monthly income you receive represents both principal and interest. If homeowners in the pool pay off their mortgages early, the entire principal is returned to the investors.

Government agencies guarantee both principal and interest payments whether they are paid on schedule or prepaid. So, though the timing of the return is unpredictable, the return of your principal is guaranteed.

CMOS

Collateralized mortgage obligations are backed by pass-through pools. They were developed to create different classes of bonds from the cash flow achieved by a specific group of pass-through pools. Some of the bonds pay interest and principal; others pay only interest for a fixed period, and then pay principal and interest. Given the range of structures, CMOs fit a wide variety of investment objectives. CMOs, like pass-through pools, set no schedule for the return of your principal, since those payments come from the underlying pools.

ISSUERS OF MORTGAGE-BACKED SECURITIES

With mortgage-backed securities, your interest and principal are backed by the agency that issued the security. However, mortgage-backed securities are not guaranteed by the full faith and credit of the U.S. government.There are three primary issuers:

- Government National Mortgage Association – Also referred to as GNMA or Ginnie Mae, this issuer carries the full faith and credit of the U.S. government. So, it offers risk similar to a U.S. Treasury security.
- Federal Home Loan Mortgage Corporation – Also known as FHLMC or Freddie Mac, this is a government-sponsored entity and carries a AAA credit rating.
- Federal National Mortgage Association – Commonly known as FNMA or Fannie Mae, this is a government-sponsored entity and carries a AAA credit rating.

BENEFITS OF INVESTING IN MORTGAGE-BACKED SECURITIES

When you invest in GNMA, FHLMC or FNMApass-throughs or collateralized mortgage obligations, the backing of U.S. government agencies means less risk for your investment. Though this is an important advantage, pass-throughs and CMOs also offer other benefits you'll want to consider.

STEADY INCOME

With mortgage-backed securities, you receive prompt monthly payments on your investment, regardless of whether the underlying mortgage payments have been collected. GNMA guarantees timely payment of both principal and interest; FHLMC and FNMA guarantee timely payment of interest and the ultimate payment of principal.

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HIGHER YIELD

In return for the variability of the timing of the return of principal, mortgage-backed securities usually provide higher yields than many other AAA-rated securities. New issue pass-through pools require a minimum deposit of $25,000, although older pools can be purchased for as little as $2,000. Most CMOs require a minimum $1,000 investment.

INVESTMENT RISKS

As with most investments, mortgage-backed securities contain certain risk characteristics. Most of these risks can be managed through proper diversification.

Generally, the higher the risk assumed by an investor, the higher the return on the securities to compensate for that risk. Investors should assess the risk/reward tradeoff when selecting mortgage-backed securities for their portfolios. In addition, if you sell these securities prior to maturity, you may receive more or less than your initial investment.

- Market risk – The chance that the price of an MBS falls if interest rates rise
- Reinvestment risk – The possibility that an investor will have to reinvest interest and/or principal at lower interest rates
- Inflation risk – The possibility that investment returns won't keep up with the cost of living
- Extension risk – The chance that, as prepayments slow, the average life of the security extends beyond the initial expectations
- Prepayment risk – The possibility that homeowners will pay off their mortgages early and, in turn, the mortgage-backed securities associated with these loans will return their principal early

TYPES OF MORTGAGE-BACKED SECURITIES

The most common type of pass-through pool is backed by 30-year mortgages. In addition, there are pools backed by 10-, 15- and 20-year mortgages. For shortterm investors, FHLMC and FNMA also issue pools backed by five- and seven-year balloon mortgages.

CMOs offer a full range of bond types. One important distinguishing factor among CMO classes is the range of variability of the return of principal. The return on some classes of these securities is well-defined (planned amortization classes - PACs); others carry a high degree of variability (companion or support classes).

WORKING TOGETHER WITH PIPER JAFFRAY

The rapidly changing financial environment we live in today has enhanced the range of investments available to meet the varying needs of individual investors. Since the possibilities are vast, the opportunities are great. Mortgage-backed securities take advantage of the low risk offered by government and agency backing. Plus, the variety of structures these securities provide allows you to tailor your investment portfolio to your financial goals.

Your Piper Jaffray financial advisor can help you determine if mortgage-backed securities are suitable for you and guide you through the various investment opportunities.

For educational information about CMOs, please contact a Piper Jaffray financial advisor.

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