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Credit Markets

Tough Times Plague Mortgage-Backed Securities

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Staff Reporters of The Wall Street Journal

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You don't have to be a high-rolling hedge-fund manager to be a loser in mortgage-backed securities. You can just be a plain old investor.

Mortgage-backed securities largely missed out on the bond market's rally of the past few years. Then, just when the worst seemed to be over, rates shot up, bonds tumbled and these securities got slammed worse than most.

What gives?

Blame it on American homeowners, whose mortgages are used to back these bonds, and whose increased financial shrewdness has been making a hash of the mortgage-backed market. After gorging on the lowest mortgage rates in about two decades, homeowners' appetites for refinancing abruptly withered as rates turned up. And as homeowners decided to hang onto their mortgages longer, prepayment assumptions fell. As a result, expected maturities of mortgage-backed bonds stretched out like silly putty.

That trapped mortgage-backed investors in a cruel twist of fate known as "extension." In the middle of the bond market's worst plunge since 1987, their supposedly high-yielding, short-term bonds suddenly turned into relatively low-yielding, long-term bonds – the worst of both worlds.

Certain mortgage derivatives, or "collateralized mortgage obligations," have been most violently torpedoed by extension. But even plain vanilla mortgage-backed securities, like the ones packed into U.S. government securities funds, have been hit. Mortgage-backed securities with coupons of 7.5% or less have been particularly vulnerable to slower prepayments, as homeowners are loath to give up mortgages with such cheap rates. (Mortgage rates now top 8%, their highest point in more than a year).

"No one expected prepayments to grind to a halt like this," says Guy Cecala, publisher of Inside Mortgage Securities, an industry newsletter.

The repercussions can be seen in the Salomon Brothers mortgage securities index, whose average maturity now is slightly longer than a seven-year bond. In the fourth quarter of last year, that same index had the profile of a 4.6-year bond.

In practical terms, that means that mortgage securities are almost twice as sensitive to interest rate swings as they were just a few months ago. For instance, if rates rose another one percentage point from today's levels, the average mortgage-backed bond would fall about 4.3% in price. In late 1993, a one-percentage-point rise in rates would have caused such a bond to fall only about 2.5% in price. That's the opposite of what happens to normal bonds, such as U.S. Treasury bonds, which tend to get slightly less prone to losses as rates head higher.

Making things worse for mortgage-backed investors is that their yields remain frozen at short-term levels even as their bonds get longer and longer. So, for instance, what seemed like a

juicy yield on a 4.6-year bond looks a lot stingier on a seven-year bond.

The market, not being foolish, factors this into the prices of mortgage-backed bonds as they extend. For instance, even if interest rates didn't budge a bit, the recent 2.5-year extension of the average mortgage-backed bond would cost investors as much as five points, or \$50 on every \$1,000 worth of bonds, says William Powers, a portfolio manager of mortgage-backed securities at Pacific Investment Management Co.

And the higher interest rates go, the more mortgage-backed bonds will extend. "That means your portfolio is always changing," in a way that short-changes investors no matter what rates do, says Mr. Powers. "To be a passive investor in mortgages," as many individual investors are, "is a recipe for underperformance," he says.

The ravages of extension are even more obvious in certain types of CMOs. These bonds are created by carving up the interest and principal cash flows from traditional mortgage-backed securities into new securities, each with its own idiosyncratic yield, maturity and other characteristics. Some CMOs are specially designed to be devoid of extension risk, while others are loaded up with more than their fair share.

Take the case of the following CMO issued by the Federal Home Loan Mortgage Corp., which goes by the catchy name of FHR 1579 PQ: This is what's known as a "tier-two planned amortization class" bond, which in simple terms means it's supposed to be somewhat insulated from extension risk. At mortgage prepayment assumptions that prevailed in early March, these bonds had the safe-looking maturities of two-year notes and fabulous yields of more than two percentage points more than comparable Treasury bonds.

That might have looked tempting, but investors should be glad they didn't take the bait. In just five weeks, as prepayment assumptions slowed, average maturities of these bonds have roughly septupled to about 15 years, and their prices plummeted.

One trader estimates that as much as 30% of the \$323 billion of new CMOs issued last year have such hypersensitivity to extension risk – much more than in prior years.

Why so much? Last year, when interest rates were low, investors were afraid mortgage prepayments would accelerate as homeowners rushed to refinance and home sales picked up. When rates are falling, prepayments hurt mortgage-backed investors because it means their bonds retire faster than expected, leaving them to reinvest their money at unappetizing yields.

Underwriters were happy to oblige investors by structuring CMOs with improved protection from prepayments. But the risk that was extracted from those CMOs, like toxic waste, didn't just go away. It had to be put somewhere. So it was dumped into other CMOs, making them all the more volatile.

Instead of stretching out just a little as rates backed up, these bonds have extended wildly, because of the complex ways that the cash flows from the underlying mortgages were designed to be distributed. Traders tell stories of two-year bonds exploding into 20-year bonds in the blink of an eye. Many of these supposedly "short term" CMOs were favored by banks and insurance companies, say Wall Street research analysts.

Extension risk is especially pronounced in "principal only" bonds. These CMOs, as their name suggests, receive only principal payments from the underlying mortgages. They're sold at deep discounts from face value, like zero-coupon bonds, and investors get no cash except from principal repayment. But as rates rise and prepayments slow, POs' average lives can easily extend to 22 years from five years, says Pimco's Mr. Powers.

Prices of POs have plunged in recent weeks. For example, POs backed by 8.5% mortgages lost 10% of their value by the time rates backed up just 0.5 percentage point, traders say. Meanwhile, POs with 6.5% coupons – whose prepayments have just about dried up – were recently quoted at a price of 58 cents on the dollar, down a stunning 27% from just a few weeks ago.

--- Going to Great Lengths

How a CMO's estimated maturity can extend as rates rise (example based on the Freddie Mac 1579 PQ, a supposedly safe "planned amortization class")

+2.00 percentage points 19.23 years +1.00 percentage point 17.67 years At today's rates
15.40 years -1.00 percentage point 2.77 years -2.00 percentage points 1.10 years

Based on dealer estimates

Friday Market Activity

The session began under the cloud of a front-page story in the New York Times describing the Federal Reserve's intentions to raise interest rates. The story was widely believed to have little information that was new to the market. But it confirmed the prevailing bearish sentiment. Its placement on the front page led many to speculate that the Fed may have been trying to send a message.

Most of these views were generated in overseas trading late Thursday night and early Friday. The lower prices carried through into the early morning hours of New York trading, with the benchmark 30-year bond down 3/8 of a point.

When the industrial production and capacity utilization figures were released, however, the market picked up, erasing most of the losses. Prices then bounced around most of the session to end mostly higher.

The Federal Reserve reported early in the session that U.S. industrial production rose 0.5% in March, compared with a 0.6% rise in February. Economists had expected an increase of 0.6% in March.

Also, capacity utilization reached 83.6% in March, up from 83.4% in February, but not enough to spark worries that the economy is growing at a gangbuster pace. Still, the figures marked a continuation of the trend that has driven Fed policy this year.

Bond investors fear robust economic growth because it can lead to inflation, which reduces the value of investments with a fixed rate of return.

On Friday, the price of the benchmark 30-year bond rose just 1/32 to 87 14/32 to yield 7.28%, virtually unchanged from Thursday.

James Kenney, head trader at Prudential Securities Inc., said he finds it difficult to make too much out of any economic figures, particularly ones that confirm what has been obvious. Market participants have reacted positively to numbers in the past, only to have the market suddenly retreat.

"That'll be the scenario we'll watch for a while here," Mr. Kenney said. "The Fed has chosen the direction of rates – now the question is how high will they go." That will depend on how much the Fed raises rates and how robust the economy develops as the year goes on. "Those are the questions that are unanswered," Mr. Kenney said.

Debate about when the Fed will raise short-term rates again has been split between those who believe it will raise rates before the next Federal Open Market Committee meeting on May 17, and those who believe the Fed will move earlier.

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