

# Understanding Mortgage-backed Securities



If you financed your home, there's a good chance that your mortgage is backing up a publicly traded security. That's because a high percentage of individual mortgages originated by banks and other lenders are ultimately pooled and used as collateral to issue mortgage-backed securities (MBS), which are then sold to investors.

## What Are Mortgage-Backed Securities?

As the name implies, mortgage-backed securities are bonds backed by pools of mortgage loans. In the most basic type of MBS, homeowners' mortgage payments are passed through to the bondholder, meaning the bondholder receives monthly payments that include both principal and interest. This is a key difference between MBS and other bonds such as Treasuries, which pay interest every six months and return the whole principal at maturity.

There are several steps involved in creating mortgage-backed security:

- ▶ A mortgage lender, such as a bank, extends a loan to a homeowner.
- ▶ The mortgage lender then sells the loan to one of the government-sponsored enterprises, agencies such as Fannie Mae or Freddie Mac, or to a private entity, like a bank or finance company. (See below for more on MBS issuers.) The lender may still service the mortgage, making this process invisible to the borrower.
- ▶ The agency or private entity then takes a number of the mortgage loans it has purchased and bundles them together into a "pool." The actual number of individual mortgages in the pool can vary from a few to thousands of loans.
- ▶ The agency or private entity then sells claims on the cash flow generated by the mortgage pool to investors, in the form of securities. After the initial sale, MBS trade on the open market.
- ▶ Mortgage payments, consisting of interest and principal, are passed through the chain, from the mortgage servicer to the bondholder.

## Who Issues Mortgage-Backed Securities?

MBS are issued and/or guaranteed by a U.S. government or government-related agency or by a private entity. Three major agencies are responsible for the majority of MBS issuance:

### Government National Mortgage Association (GNMA)

GNMA, or Ginnie Mae, is a government agency that guarantees mortgage securities issued by approved private institutions (mostly mortgage lenders). GNMA securities are the only MBS backed by the full faith and credit of the United States, the same guarantee afforded U.S. Treasury bonds. This guarantee assures investors of the timely payment of interest and principal.

### Federal National Mortgage Association (FNMA)

FNMA, or Fannie Mae, is a government-sponsored enterprise. It is a publicly owned corporation that operates under a Congressional charter with U.S. government oversight. Fannie Mae both issues and guarantees mortgage securities. Although its securities are not backed by a U.S. government guarantee, they carry an implied AAA credit rating. On September 6, 2008, the Federal Housing Finance Agency (FHFA) was appointed as the conservator of Fannie Mae.

### Federal Home Loan Mortgage Corporation (FHLMC)

FHLMC, or Freddie Mac, is also a government-sponsored enterprise and operates in much the same way as its competitor Fannie Mae does. Its securities likewise possess an implied AAA-level credit quality. On September 6, 2008, it too came under the conservatorship of the FHFA.

There are also private companies that issue MBS. These private-label securities are typically issued by homebuilders or financial institutions through subsidiaries and are backed by residential loans that do not conform to agency requirements. Private-label MBS are rated by rating agencies and often feature credit enhancements, such as overcollateralization or letters of credit, which are designed to help protect investors from delinquencies or losses on the underlying loans. There is no assurance that private insurers of mortgage-backed securities will meet their obligations.

## Why Do MBS Often Offer Higher Yields Than Similar High-Quality Bonds?

Federal agency mortgage-backed securities tend to have high credit quality because they are backed by the residential real estate underlying the loans and by the issuing agency. Even so, MBS have historically offered higher yields than bonds of similarly high credit quality, such as U.S. Treasuries, to compensate for a risk factor not present with Treasuries.

Unlike Treasuries, MBS are subject to the risk of mortgage refinancing. An investor buying a 30-year Treasury can hold that bond and collect the same interest payments for 30 years. However, an investor buying an MBS backed by a pool of 30-year mortgages will collect the stated interest rate for an uncertain period of time because few homeowners will actually hold their mortgages for the full 30 years. Some will refinance their mortgages when interest rates fall, and others will sell their homes before the mortgage is paid off. In either case, the mortgages are paid early and investors in the MBS backed by those mortgages receive their principal back before the full term of the loans.

Because these mortgage prepayments typically accelerate when interest rates fall, MBS investors may find themselves needing to reinvest their money in other low-interest-rate securities. Conversely, when rates rise, prepayments tend to slow, and investors receive lower-than-expected prepayments at a time when it would be an advantage to invest elsewhere. To compensate MBS investors for this uncertainty, an anticipated level of prepayments, based on historical data, is factored into the price and yield of any MBS.

## Types of Mortgage-Backed Securities

Mortgage-backed securities can be structured in a number of ways. Here are the two most common types:

### Pass-Throughs

Pass-through securities, also known as participation certificates, are the most basic mortgage-backed bonds and are collateralized by pools of similar mortgage loans. Most are issued and/or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac. As the name suggests, the cash flow from the underlying mortgage payments is passed through to the MBS investor.

## Collateralized Mortgage Obligations (CMOs)

CMOs are structures that may utilize pools of pass-throughs and/or mortgage loans as collateral. CMOs are typically separated into three or more bond classes, generally called “tranches,” each of which has its own expected maturity and cash flow pattern. Some CMO’s are stable, lower risk investments relative to pass-throughs, while others are more volatile. The unique cash flow patterns and risk/return characteristics of each CMO tranche allow investors to tailor their mortgage exposures to meet a range of investment objectives. The yield and average life of a CMO reflect prepayment assumptions, which may or may not be met. Changes in mortgage payments may significantly affect yield and average life.

## Use of Mortgage-Backed Securities in Mutual Funds

Mortgage-backed securities may be a primary or significant component of a mutual fund portfolio. They can be attractive because of their yield characteristics and their creditworthiness. However, it’s important to know that the guarantees that apply to individual government-sponsored MBS as to the timely payment of interest and principal do not apply to mutual fund shares, which can fluctuate in value and may experience losses. The prepayment risk that can affect the value of individual mortgage-backed securities in a mutual fund may also affect the value of those fund shares.

## Conclusion

Mortgage-backed securities, backed by pools of individual mortgage loans, are primarily issued by federal agencies such as Ginnie Mae, Fannie Mae and Freddie Mac. The high credit quality and attractive yield of these securities relative to other high-quality bonds have helped them grow into the largest sector of the U.S. bond market.

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