

Perspectives

FROM OPUS INVESTMENT MANAGEMENT



“Hybrid ARMs”

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What they are

ARMs, or Adjustable Rate Mortgages, have been around since the late 1980s. Originally, these loans reset on an annual basis; rates generally changed each and every year. In addition, many of these loans included a below-market, teaser rate for the initial year. Because these features subjected the borrower to a great deal of uncertainty, the “hybrid ARM” product was developed and has become dominant in the adjustable rate mortgage market. Hybrid ARMs generally amortize over a 30-year period. (Note that many “interest-only” mortgages are presently being originated. For hybrid ARM interest-only mortgages, borrowers commonly pay only interest for the initial fixed period; amortization kicks in during the floating period.)

Hybrid ARMs combine the advantages of the original ARMs with those of traditional fixed rate mortgages. The initial rate of interest is fixed for several years; afterwards the rate will float based on a margin over a pre-established index. The initial fixed period is generally 3, 5, 7, or 10 years, while the floating rate most commonly resets on an annual basis. Because of this, hybrids are commonly denoted as 3/1s, 5/1s, 7/1s, or 10/1s. This flexibility allows the borrower to choose a loan that matches his/her specific time horizon. Hybrid ARM rates are almost always set so that the quoted 3/1 rate is the most appealing, followed by the 5/1, 7/1, and 10/1 in order. In addition, since currently all the initial hybrid rates are lower than a fixed-rate 30 year mortgage, a borrower may afford a larger house, or better manage cash flow for several years.

Currently, the most common indices are the 1-year Constant Maturity Treasury (CMT), 1-year LIBOR, or 6-month LIBOR. After the initial fixed period, mortgage rates are determined based on an index plus a margin, typically 225 - 275 basis points for 1-year CMT, or 175 - 225 basis points for 1-year LIBOR. To alleviate any potential rate shock, hybrid ARMs include a series of caps that may limit the size of the rate increase. Three caps are most commonly quoted - an initial cap, a periodic cap, and a lifetime cap. For example, a cap structure of 5/2/6 indicates a ceiling of 5% on the initial rate increase, and 2% on any subsequent increase. The final 6% is a limit on cumulative increases over the lifetime of the loan. Most 3/1 hybrids have 2/2/5 caps, while the longer hybrids would utilize 5/2/5 or 5/2/6 structures.

The market

As is the case with fixed-rate mortgages, hybrid ARM mortgages are pooled together and offered to investors. One important distinction is between agency pools, which are guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae, and non-agency pools, in which the investors bear the default risk. The size of the agency market is estimated at \$400 billion, the non-agency market at \$900 billion (as a reference, the U.S. Treasury market is approximately \$3.6 trillion).

The market has shown great growth over the last 5 years. In 2001, only 5% of new agency mortgages, and 19% of non-agency, were hybrids. For 2006, these figures have grown to 17% and 85%, respectively.

About 60% of these loans are 5/1 hybrids; 3/1s and 7/1s are approximately 17% each, with 10/1s making up the balance. As the Fed has raised interest rates and the yield curve has flattened, the share of 3/1s has declined somewhat, and longer hybrids have increased in popularity.

Risks

First, all mortgages harbor prepayment risk. If rates go down, borrowers refinance, and investors must reinvest in a lower interest rate environment. Conversely, if rates rise, borrowers are more likely to stay with their current mortgage. Investors see their bonds extend in duration, and miss out on reinvestment opportunities in a higher rate environment. Not only do hybrid ARMs present these risks, but arguably the risks are somewhat magnified. First, the introduction of hybrid products has created the potential for new refinance incentives. A hybrid borrower may refinance into another hybrid as well as into a fixed rate mortgage. For example, a hybrid borrower may find it advantageous to lock in a fixed rate, especially if the yield curve has inverted and the difference in rates has narrowed. Second, since hybrids are relatively new, there is simply less data concerning borrower refinance activity. This is especially important around the reset date, where borrowers often have a huge incentive to refinance, and prepayments generally peak. To illustrate, today's 5/1 borrower might expect to see his monthly payment jump by as much as 35% after the fixed period expires.

Second, as alluded to above, non-agency mortgages are not guaranteed in the manner of their agency counterparts. Investors generally bear the risk that the borrower will default. Before these mortgages are made available to investors, they are generally structured so that a range of bonds may be offered. The lower-rated bonds will absorb the first credit losses, allowing the creation of higher-rated classes which are virtually free of credit risks. We at Opus will be buying only AAA-rated mortgages for the foreseeable future.

Finally, trading of fixed-rate mortgages is greatly facilitated by the presence of a TBA market (To Be Announced, or generic mortgages, which trade based solely on agency, coupon, and maturity). This huge market provides liquidity, price transparency, and a ready market for almost any fixed-rate pool with minimal transaction costs. A TBA market has not developed around hybrid ARMs, and frankly, we do not expect this to happen. Consequently, liquidity will not be quite as good as for fixed-rate mortgages, and bid-ask spreads will generally be larger.

Opportunities

Risks create opportunities, and we believe, on balance, that this is a good time to invest in hybrid ARMs. In support of this recommendation, we offer the following comments:

- (1) Although prepayment risk exists with all mortgages, we at Opus utilize state-of-the art models to analyze and quantify these risks. Based on this analysis, we believe that there is now considerable value in hybrids. We especially feel that the floating rate portion has considerable value that is not being reflected in current market pricing.
- (2) 50% of the fixed-rate mortgage index is concentrated in just two coupons, 5s and 5½s. Consequently, investors need to consider out-of-index alternatives to add value to their portfolios. The hybrid market is large enough to offer both diversification and potential alpha.
- (3) In August 2005, Lehman Hybrid ARM Index was introduced, consisting entirely of agency pools. However, the index was originally used only for tracking purposes; it was not part of the Lehman Aggregate. We at Opus felt that this would change, and accordingly, we began buying hybrid ARMs early in 2006. As we go to press, Lehman has just announced that the Aggregate will be expanded to incorporate hybrid ARMs, effective April 1, 2007. As hybrids will constitute roughly 4% of the Aggregate (slightly larger than Ginnie Maes), we feel that the investor community will be purchasing hybrid ARMs in large quantities. At a time when spreads are tight and opportunities are difficult to find, getting ahead of that trend may well be a winning trade.