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MORTGAGE PASS-THROUGH SECURITIES

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION - GNMA - GINNIE MAE
FEDERAL NATIONAL MORTGAGE ASSOCIATION - FNMA - FANNIE MAE
FEDERAL HOME LOAN MORTGAGE CORPORATION - FHLMC - FREDDIE MAC

I call "mortgage pass-through" securities (GNMAs, FNMAs, and FHLMCs) "heads, you don't win; tails, you lose" securities. In this regard, they are almost identical to callable bonds.

At any given point in time, the inducement to purchase mortgage pass-through securities (or callable bonds) is the fact that their indicated current yields and/or yields-to-maturity are higher than the indicated yields on non-callable bonds of comparable credit quality and maturity.

As with all investments, there is no free lunch. Some sacrifice must be made for this incremental yield. In fact, the increment is better described as a "phantom" incremental yield. Over time, the added dollars enjoyed by an above-average rate of return today must be paid back with a below-average rate of return tomorrow.

In the case of mortgage pass-throughs, the demon is not the "calling" of the security, but rather what are known as "prepayments" on the security.

Let us assume any one of three scenarios. First, if interest rates never change, admittedly, the owner of the mortgage pass-through security will enjoy a higher average return than the owner of a comparable non-callable bond.

But interest rates are extremely volatile and have been getting increasingly volatile over the past quarter century. If interest rates rise after the purchase of a mortgage pass-through, one is disappointed, because the price of the security declines and one

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is denied the opportunity to invest at the then higher prevailing rates. This, of course, is a downside with a non-callable bond as well.

The downside of the mortgage pass-through, that is not a downside of a non-callable bond, however, is that, when interest rates go down, homeowners refinance their mortgages, and the owners of mortgage pass-throughs find themselves with returns of principal (prepayments) that they must reinvest at the then lower rates of interest.

In short, we have an investment that says, if interest rates go up, you cannot enjoy the higher rates (heads, you don't win); but, if interest rates go down, you will be forced to trade your high rates for the new lower rates (tails, you lose).

An analogy that illustrates the deceptive character of mortgage pass-through securities is that of a depositor who puts money into a bank account that earns interest at the rate of 5%, tells his bank to disburse funds to him at the rate of 10%, and then boasts that he has money in a bank that pays 10%. Eventually, reality catches up with him.

I have never known a mortgage pass-through investor who did not eventually become disillusioned and disappointed with his investment; but it is only after interest rates have made a major move - either up or down - that he is most likely to become aware of the true nature of the beast.

If one wants a fixed-income security, it is pretty hard to beat a simple, non-callable U. S. Government bond or bill - the safest and most straightforward of all fixed-income securities.

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