FACT SHEET ON CMOs

- Called a Collateralized Mortgage Obligation or CMO
- A type of mortgage-backed security that creates separate pools of pass-through rates for different classes of bondholders with varying maturities, called *tranches*
- Repayments from the pool of pass-through securities are used to retire the bonds in the order specified by the bonds' prospectus
- Minimum denominations of $1,000
- Backed by agency pass-through securities
- CMOs usually offer low returns because they are very low risk and are sometimes backed by government securities.
- Most would be rated AAA
- They do not have a liquid secondary market, due to their complexities
- Brokers must use extra care to determine suitability due to the complex nature of the product
- CMOs are derivatives (as are options)
- PAC stands for "planned amortization class"
- PACs are protected from prepayment risk and extension risk
- TAC stands for "targeted amortization class"
- TACs present more extension risk, the risk that principal will be paid back too slowly
- TACs generally yield more than PACs
- The "companion bond" is used with a PAC to provide the prepayment protection
- The companion bond is designed to absorb excess principal payments during times of high prepayment speeds and defer receiving principal payments during times of low prepayment speeds.
- Interest-Only (IO) and Principal-Only (PO) CMOs are riskier
- IOs and POs are created by stripping apart the interest and principal cash flows and creating separate bonds.
- Principal-Only bonds receive a fixed total payment, so the sooner prepayments occur, the better the yield
- Interest-Only bonds receive variable total payments, so prepayment risk is severe on IOs
- POs rise in value when interest rates drop
- IOs drop in value when rates drop due to increasing prepayment risk

**EXAMPLE** of how a very simple CMO works: The investors in the CMO are divided up into three classes. They are called class A, B or C. Each class differs in the order they receive principal payments, but receives interest payments as long as it is not completely paid off. Class A investors are paid out first with prepayments and repayments until they are paid off. Then class B investors are paid off, followed by class C investors. **In a situation like this, class A investors bear most of the prepayment risk**, while class C investors bear the least.
POSSIBLE EXAM QUESTIONS:

1. All of the following are characteristics of CMOs except:
   A. minimum denominations of $1,000
   B. speculative credit rating due to interest rate risk
   C. backed by agency pass-through securities
   D. interest is paid monthly and is fully taxable

2. Regarding advertising for CMOs, which of the following statements is inaccurate?
   A. Advertising materials must be filed 10 days prior to use
   B. Advertising materials are approved or disapproved by the SEC
   C. Disapproved advertising must be re-filed and approved before it is used
   D. CMOs may not be compared to any other types of investments

3. Which of the following is an accurate statement regarding CMOs?
   A. interest is paid to early tranches and then later tranches
   B. principal is returned to one tranche at a time
   C. principal is returned only upon demand of the investor
   D. prepayment risk is not a consideration

4. Which of the following represents an inaccurate statement regarding CMOs?
   A. a companion bond is used with a PAC to provide prepayment protection
   B. the companion bond absorbs excess principal payments during times of high prepayment speeds
   C. CMOs trade on a liquid secondary market
   D. CMOs are derivatives and suitable for more sophisticated investors

5. Which of the following represents an accurate statement concerning PACs and TACs?
   A. PACs present more extension risk to the investor
   B. TACs provide more protection from prepayment risk
   C. PACs provide more protection from extension risk
   D. TACs are purchased only in tax-deferred, non-institutional accounts

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+ANSWERS: 1 – B  2 – B  3 – B  4 – C  5 - C

For a more detailed look at CMOs, please visit:

http://www.riskglossary.com/link/collateralized_mortgage_obligation.htm