COASTAL SECURITIES

Can You Say "ARMs" and "Total Return" In the Same Breath?

Foreclosures mean bad news for homeowners, but great news for investors.

June 20, 2006

Financial Strategies Department
5555 San Felipe Ste. 2200
Houston, TX 77056-2725
(713) 435-4382
www.coastalsecurities.com

Despite mixed economic data, many indicators point to a slowing domestic and global economy. With sixteen consecutive Fed funds rate hikes behind us and number seventeen a near certainty, the Federal Reserve has made it clear that it remains very hawkish regarding the battle against inflation. On the surface, this does not bode well for fixed income or equity investors as stormy weather has pounded these markets throughout the last few weeks. What's an investor to do in these uncertain times?

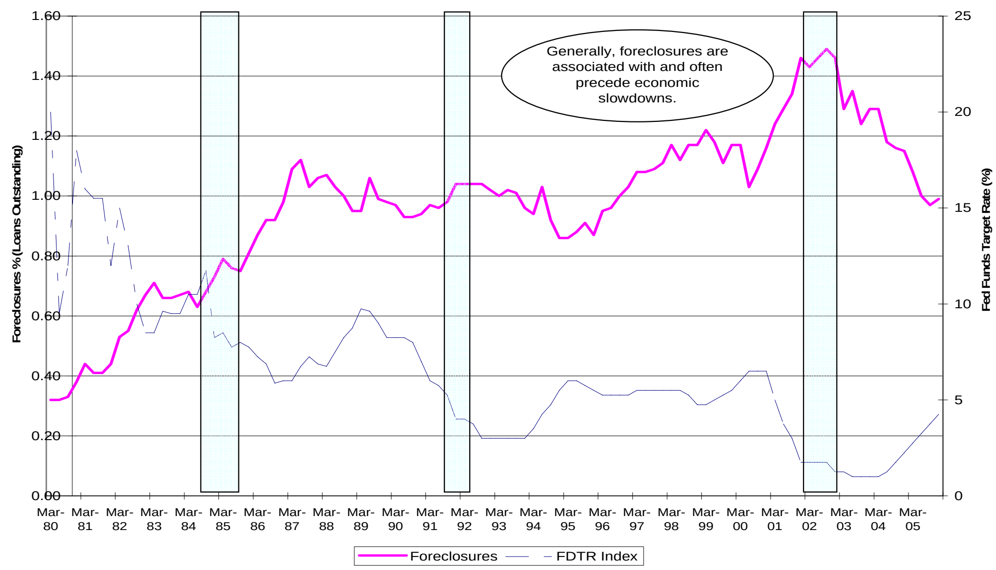
As always, there's a silver lining to every dark cloud and a remarkable silver lining continues to reveal itself to Coastal's ARM MBS investors. Coastal's ARM clients have plenty to brag about when it comes to their adjustable rate portfolio's performance. Throughout the past year, we have advised the purchase of 3/1, 5/1, and longer reset Hybrid Arms and have been extremely pleased with the results for our clients. Increased prepayments and coupon income has and will continue to reward those who own discount MBS ARMs.

So why are these ARM investors sitting pretty when many in the market are left wondering where to place their investing dollars? It's no secret that the housing market has begun to soften. The average interest rate on a 15 year fixed rate mortgage has risen 60 bps from 5.57% in January. Similarly, the average 30 year fixed rate has risen to 6.52% from 6.06% in the same time span. Many homeowners who took out ARM loans when short term rates were historically low are in for an awakening. In aggregate, the market is in a precarious position as over $3 trillion worth of adjustable rate mortgages are scheduled to re-price at the higher prevailing interest rates in the next eighteen (18) months. Many individual homeowners will not be able to afford the increased payments.

As indicated in the press lately, many homeowners have already given up. During 2005, the delinquency rates from prime ARM loans were up 43 bps to 2.54% while fixed rate loan delinquencies increased only 17 bps.[1] Nationally, foreclosures are up 38% in the first quarter of 2006 – the highest quarterly increase in a year.[2] Additionally, national foreclosures are likely to reflect a "Katrina-effect"; foreclosures in Mississippi and Louisiana are lower

[1] This data according to Bloomberg.
[2] This according to The Chicago Tribune.

than “normal” due to forbearance opportunities offered by lenders immediately following the storm, causing an under-estimate of “true” rates of foreclosure.



While this is bad news for mortgagors with ARM loans, it is great news for investors who have purchased discount ARM securities. ARM portfolios can be expected to shorten in the coming months as ARMs lead MBS foreclosures in 2007. When these discount ARMS prepay due to foreclosures, the investor receives par value on their security. Depending on the degree of discount at which the ARM security was originally purchased, the upside potential in this situation can be tremendous. Purchasing these discount ARMs in anticipation of their foreclosure-related payoffs is still an advantageous opportunity!

There are more ARMs as a percentage of total MBS out there today as a result of extended periods of low short term interest rates that prevailed from 2001 - 2003. For example, in 2002 ARMs made up little over 9% of total agency MBS issuance, and by 2005 ARMs represented 16.5% of agency MBS issuance. Many of these ARMs re-price as a function of one year LIBOR which is currently at 5.5%. 3/1 LIBOR based ARMs can be expected to increase over 200 bps in coupon costs as they reset at roll date. 5/1s and 7/1s have 5/2/5 cap structures for the most part. As a result, some borrower’s monthly payments will nearly double! There has been a historical precedent for what we are currently seeing with regard to the increase in foreclosures. The percentage of delinquencies to total outstanding loans increases just prior to recessions, as shown above. It’s a safe bet that increased foreclosures will continue as a result of the higher P&I payments due on ARM loans.

Recall the relative value progression of hybrid ARMS throughout 2005. Early in 2005, spreads on 3/1s compressed from 37 bps to 29 bps as supply dwindled before eventually widening out to 47 bps by January 2006 as more 3/1 ARMs were issued. History repeats itself and the cycle is beginning again. 3/1 ARM supply on the secondary market is becoming more scarce, net new issuance is negative, and spreads are tightening. Given the current trend in foreclosures, the supply of 3/1’s is expected to dwindle at the same time existing product pays off. Today, an investor can purchase a 3/1 ARM with roll dates between 1 ½ and 2 years away, as described below. Consider the following 3/1 ARM with about 2 years to its roll date:

FN828975

Coupon	Stated Maturity	Issued	Face Value	Rate Change
4.565%	7/01/35	7/01/05	$16,840,209	2/01/08

Assuming that an investor purchases the pool at $98.25, he/she will receive principal and interest payments yielding 5.63% (using CPB = 25%). If interest rates are higher at the February '08 roll date, there is a strong possibility that a portion of the pool will be paid off due to foreclosure which results in a higher return to the pool buyer. While the impact to the homeowners is beginning now, the effects for investors may lag depending on the state in which the real estate is located and their foreclosure procedures. An even more attractive opportunity exists in ARMs with longer roll dates. Take the following ARM for example:

FN834927

Coupon	Stated Maturity	Issued	Face Value	Rate Change
5.063%	7/01/35	7/01/05	$155,585,691	01/01/10

An investor who purchases this pool at $98.25 (using CPB = 25%) will realize a 5.77% yield on the principal and interest payments received. By moving out two years on the roll date on a pool with the same stated maturity, investors can pickup 14 bps in yield!

Despite the increase in coupon income, portfolio managers can expect to see a fall in ARM portfolio's durations as a result of these foreclosures and prepayments. An asset sensitive fixed income portfolio makes good sense in this economic environment. The yield on short duration product such as the Hybrid ARMs described in this article is attractive on a risk adjusted basis given the shape of the yield curve. The Fed continues to be concerned about inflation and will fight it on the short end. However, the long end of the curve will be impacted by the sustained higher energy prices and political risk which will impact the risk to longer duration fixed income product.

All in all, discount ARMs once again have relative risk adjusted value in today's marketplace. ARM buyers who have already very wisely positioned these instruments in their portfolios should "thump chest" as total return statistics from the ARM sector of their fixed income portfolio outperform other portfolio sectors. Given anticipated higher future cash flows from coupon and principal dollars and relatively shorter durations, portfolio managers should increase ARM exposure! Yes, by adding more ARMs in anticipation of increased delinquencies and foreclosures, an investor can continue to ride this wave. These products are still available at discount prices. Consult with your Coastal Securities representative today in order to take advantage of this opportunity to add real value to your investment portfolio.