



## Step-Up & Step-Down Callable Agency Securities

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Step-Up Callable agencies are short to medium-term debt securities issued by Government Sponsored Entities (GSEs) such as Federal National Mortgage Association (FNMA), and Federal Home Loan Mortgage Corporation (Freddie Mac). The unique structure of these securities allow GSEs – which back their debt with large portfolios of qualifying mortgages - to attract investors looking for lucrative short-term investments while maintaining the flexibility to redeem this debt in the event that prepayments on the underlying mortgage portfolios surge.

Step-Ups are typically issued with maturities ranging from 1 – 20 years with a pre-determined schedule of coupon rates that gradually increase or “step up” over a period of time. Most are issued with a call feature of between 3 months and 5 years which allows the issuer to call the securities back if interest rates should go lower or if their asset/liability mix should change. The first coupon rate is usually lower than that of comparable maturity securities, but investors can achieve a higher yield than can be found on shorter term agency securities. If the bonds are not called prior to the predetermined step-up schedule, the investor then receives a higher coupon rate than during the initial period. Following is an example of a recently issued FHLB Step-Up Callable agency :

FHLB 4.25 maturing 2/7/2018 callable 5/7/08 and quarterly thereafter  
Bonds offered @100

Coupon Schedule:

4.25 from 2/7/2008 through 2/7/2010  
4.75 from 2/7/2010 through 2/7/2012  
5.25 from 2/7/2012 through 2/7/2014  
5.75 from 2/7/2014 through 2/7/2016  
7.00 from 2/7/2016 through 2/7/2018

If an investor were to buy a 10-year callable agency in the current market, they could achieve more than the 4.25% that they will receive during the initial coupon period. However, 4.25% is well above the yield that can be earned on a 2 year callable agency in this market. The weighted average of all the coupons is also a higher overall rate than can be found for comparable maturity securities. Investors should understand that it is doubtful they will receive the higher coupons to be paid in the later years unless interest rates increase. If rates do go up, the increasing coupon schedule will help the security to keep pace with the markets and to minimize price erosion. Although there is a very active secondary market for Step-Up Callable Agencies, they should be purchased by investors as part of a “buy and hold” strategy.

Step Down Callable Agencies are similarly structured; however, the coupon rate ratchets downward according to a predetermined schedule. During periods where there is an inverted yield curve, this type of security can offer a yield enhancement alternative especially if

investors feel that the overall trend is for lower interest rates. Take for example this recently issued Step-Down Security:

FHLMC 5.15 3/12/2013 callable 9/12/08 and quarterly thereafter  
Bonds offered @ par

Coupon Schedule:

5.15 from 3/12/2008 through 9/12//2008  
3.85 from 9/12/2008 through 3/12/2013

The 5.15% coupon is far above any yield that can be found in the six-month agency marketplace. If rates continue to come down dramatically, chances are high that the bonds will be called and the investor nets a 6 month agency yield of 5.15%. If rates were to stay the same or go lower and the bonds were not called, the investor then has the 3.85% coupon for the remaining 4.5 years to maturity (unless the bonds are called prior to that) which is over a 100 basis point positive spread to that part of the treasury yield curve. The bonds are callable quarterly; therefore the yield to the investor gradually decreases with the very worst case yield if the bonds are held to maturity. See the Yield Chart below.

**FHLMC 5.15% 3/08**

Settlement on	3/12/2008	Price: 100.00
Yield To Maturity on	3/12/2013:	3.992
Yield To Next Call on	9/12/2008:	5.150
Yield to Worst Call on	3/12/2013:	3.992

Date	Price	Yield
9/12/2008	100	5.150
12/12/2008	100	4.729
3/12/2009	100	4.500
6/12/2009	100	4.383
9/12/2009	100	4.293
12/12/2009	100	4.234
3/12/2010	100	4.185
6/12/2010	100	4.151
9/12/2010	100	4.121
12/12/2010	100	4.099
3/12/2011	100	4.078
6/12/2011	100	4.063
9/12/2011	100	4.047
12/12/2011	100	4.036
3/12/2012	100	4.024
6/12/2012	100	4.016
9/12/2012	100	4.006
12/12/2012	100	4.000
3/12/2013	100	3.992

These specialized bond types can be a powerful yield enhancing tool as part of an overall portfolio strategy. The investor that takes the time to do the analysis and to understand the nature of these special callable agency securities can receive a higher current return than can be found on investments of comparable credit quality.

For more information, please contact your Coastal Securities representative.

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