

The Value in Hybrid Arms

First, What Are Hybrid ARM's?

Hybrid ARM's are agency pass-through securities backed by mortgage loans that carry a fixed rate for a predetermined period before becoming adjustable annually. Generally, the fixed rate period lasts for 3, 5, 7, and even 10 years in some structures. After this "lockout" period, the security becomes a traditional adjustable rate security. It is the initial fixed rate period that allows the investor to receive a higher current coupon and yield over traditional ARM structures yet comparable to traditional pass-throughs.

What Are The Benefits Of Adjustable Rate Securities?

- Provide protection against rising interest rates.
- Provide additional yield over alternative short maturity fixed rate investments.
- Offer potential price stability over fixed rate investments.
- Offer higher total return potential in a rising rate environment.
- Assist in managing interest rate risk.

Why Hybrid Arms Now?

In general, fixed-rate mortgages have tightened over the last several months, primarily due to the significant reduction in issuance following the surge in early summer. While overall mortgage origination is down from the summer pace, ARM originations now make up a much larger portion of the current origination volume. As such, Hybrid ARMs have experienced relatively light spread tightening. Furthermore, amidst the brisk prepaids experienced through mid-2004, portfolio managers are keeping an eye on the horizon and are now monitoring the potential for extension risk in their portfolios. Allocating a portion of the portfolio to Hybrid ARMs is an excellent strategy that allows the portfolio to benefit from extended interest rate increases, while providing attractive coupons and yield today. We have included two tables below that reflect the value we see in 3 x 1 & 5 x 1 Hybrid product versus similar mortgage alternatives and callable agency structures.

5 x 1 HYBRID

CPR	5- Year Balloon 4.50% 102-03		5x1 Hybrid ARM 4.522% Cpn 101-12 (253 margin 56 months to roll) Balloon @ 100 Yield*	Alternatives
	Yield	Avg Life		
15	3.78	3.27	3.99	3 Yr/1 Yr Callable 3.35%
20	3.68	2.89	3.92	
25	3.57	2.56	3.84	3 Yr Pac 4.00% Cpn
30	3.46	2.26	3.76	
35	3.33	2.00	3.66	5.5% Collateral 3.69% yld
40	3.18	1.77	3.55	
45	3.01	1.56	3.43	Rates up 100 3.69% yld 3.99 AL
50	2.81	1.38	3.30	
55	2.59	1.22	3.14	

* Yields on hybrid arms assume balloon at reset date at an indicated price

3 x 1 HYBRID

CPR	3x1 GNMA Hybrid ARM 4.25% cpn 101-01 (150 margin 36 months to roll) Balloon Yield*			3x1 FNMA Hybrid ARM 4.226% cpn 101-25 (170 margin 34 months to roll) Balloon Yield*			Alternatives
	@100	@101	@102	@100	@101	@102	
15	3.65	3.89	4.13	3.29	3.54	3.80	2.5 Yr/1 Yr Callable 3.12%
20	3.60	3.82	4.04	3.21	3.45	3.68	
25	3.55	3.74	3.94	3.13	3.34	3.55	
30	3.48	3.66	3.83	3.04	3.23	3.41	2.5 Yr Pac 4.00% Cpn
35	3.41	3.57	3.72	2.94	3.10	3.27	
40	3.33	3.47	3.60	2.83	2.97	3.11	5.0% Collateral 3.23% yld
45	3.24	3.37	3.48	2.70	2.82	2.94	
50	3.14	3.25	3.35	2.56	2.66	2.76	Rates up 100 3.22% yld 2.54 AL
55	3.03	3.12	3.20	2.39	2.48	2.56	

* Yields on hybrid arms assume balloon at reset date at an indicated price.

Of particular interest in the 3x1 area is the GNMA product which was created approximately one year ago. The ability to add GNMA (full faith and credit) with the hybrid structure is an attractive alternative for those looking to diversify out of FNMA and FHLMC. The major structural difference between GNMA and FNMA/FHLMC is the cap structure. GNMA's have 1% periodic and 5% life caps versus 2% periodic and 6% life caps for FNMA/FHLMC. As reflected in the table, the GNMA's yield advantage provides a measure of compensation for the cap differences.

Within the world of agency credits, Hybrid ARMs represent a compelling value versus other mortgage and non-mortgage alternatives, in our opinion. Portfolio managers seeking attractive coupons and yields, while looking for products that may offer extension protection and have the potential for price stability in a rising rate environment, should take a close look at this product.

Tommy Wammack

**Institutional Fixed Income
Portfolio Strategies & Analytics Group
615-341-6002**

- Additional information is available upon request.
- Baird or its employees may have a long or short position in the securities mentioned, and buy or sell the securities from time to time.
- Baird trades these securities as principal from its inventory.
- The information contained herein has been obtained from sources we consider reliable, but we cannot guarantee the accuracy.

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. Baird may function as a market maker in any of these securities trading in the over the counter market. Publication of this document in the United Kingdom is directed at, and is only made available to, authorized persons and other persons falling within COB 3.2.5(1) (b) of the FSA Handbook, and may not be distributed to private clients. Issued in the United Kingdom by Robert W. Baird Limited, which has an office at Mint House 77 Mansell Street, London, E1 8AF, and is a company regulated by the FSA. The Dow Jones Industrial Average, S&P 500, S&P 400 and Russell 2000 are unmanaged common stock indices used to measure and report performance of various sectors of the stock market; direct investment in indices is not available. OUR COMPANY OR ITS OFFICERS, EMPLOYEES OR CUSTOMERS MAY HAVE A POSITION LONG OR SHORT IN THE SECURITIES MENTIONED AND BUY OR SELL THE SECURITIES FROM TIME TO TIME.
Baird Limited, a company regulated by the SFA.

A Wealth of Advice.SM Baird