

## Hybrid ARMs

### *Armed for the Future, yet Providing Attractive Yields Today*

#### Current Interest Rate Environment

The Fed Funds target rate stayed at 1% for just over a year. Beginning on June 30, 2004 The Federal Reserve has increased the Fed Funds rate in 3 successive 25 basis point moves. Conversely, since the Fed began to raise the Fed Funds Rate, the yield on the 5-year Treasury Note has fallen by 40 basis points. The question facing portfolio managers is, "What's next?" Put another way the question is, "Where are we in the interest rate cycle?" Some believe the Fed will continue to raise the Funds Rate gradually while others believe more dramatic increases are coming. Still others believe that The Fed has gotten ahead of itself.

#### *Dilemma:*

Over time, many portfolios have need to own adjustable rate securities. This need for adjustable rate securities creates quite a dilemma given the current yield curve and the overall uncertainty as to where the current market fits within the interest rate cycle. The issue for portfolio managers considering Adjustable Rate Mortgage Backed Securities (ARMs) is, "How long do I have to live with very low coupons?" With the Fed having begun to increase short-term rates, the growing question relates to the pace of short-term rate increases going forward. The perceived need to own short repricing assets remains at odds with the need for current income. Buying one year ARMs with reset dates of 12 months or less, while reducing a portfolio's repricing term, may significantly reduce the portfolio yield for an extended period if The Fed cannot sustain its current pattern of rate increases.

#### *Solution:*

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 yields today.

#### *What Are Hybrid ARMs?*

Hybrid ARMs are agency pass-through securities backed by mortgage loans that carry a fixed rate for a set period of time before becoming adjustable annually. Generally, the fixed rate period lasts for 3, 5, 7, or even 10 years. After this period, the security becomes an ARM with a coupon that floats based on a specific short-term interest rate, typically the one-year Constant

Maturity Treasury Index (one-year CMT) or LIBOR. Hybrids are generally referred to by their initial fixed period followed by their coupon reset interval going forward. A 3/1 Hybrid ARM has an initial fixed rate period of 3 years, and then resets annually; a 5/1 has a 5 year fixed rate period, etc. Portfolio managers contemplating the need for one-year ARMs generally should focus on Hybrids with fixed rate periods of 5 years or less. 7/1 and 10/1 Hybrids are generally viewed as fixed rate alternatives.

### *Why do investors like Hybrid ARMs?*

- Attractive duration/coupon combination
- Good size availability
- Good liquidity
- Good carry versus funding cost without prohibitive premium
- Agency issued (FNMA, FHLMC, GNMA)
- ERISA and SMMEA eligible

### **Bottom Line**

For portfolio managers who have future needs to own adjustable rate securities, yet believe that short-term interest rates will remain near current levels, Hybrid ARMs are an attractive solution. An ample supply of Hybrids allows for building this sector with a ladder of reset dates between 12 and 40 months. Either from reinvestment of cash flows or coupon resets, this sector should reflect the level of short-term interest rates over this 2- to 4-year time frame. Additionally, a combination of rising rates and reset dates shortening below 12 months should produce attractive price performance, as demand will likely accelerate.

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