



Mortgage Backed Report

Mortgage Backed Securities – CMO Retail/Lottery Bonds

Collateralized Mortgage Obligations (CMOs) are a security backed by a pool of pass-through securities, which are in turn secured by mortgage loans. Usually they are issued by a U.S. Government Agency such as Government National Mortgage Association (Ginnie Mae) Federal Home Loan Mortgage Corp. (Freddie Mac) or Federal National Mortgage Assoc. (Fannie Mae).

When CMOs are structured and issued, they are usually divided into different tranches or classes to meet varying needs and objectives of bondholders. The principal and interest of the underlying mortgages is passed through to the various classes on various schedules so that, for example, one class may receive principal payments immediately while other classes may not receive any principal payments for many years.

Retail/Lottery Bonds can be created from a variety of classes including Planned Amortization Classes (PAC) and Support Classes. These classes can vary in terms of average life. While most classes of CMO's return principal on a pro-rata basis, principal on a class designated as *Retail/Lottery* is always returned to investors in multiples of \$1,000 chosen through a random lottery. *Retail/Lottery* bonds are generally identified by a "double letter" designation. For example Fhlmc 2571 "LG" is a 2.7-year average life bond designed to return principal on a pro-rata basis. The *Retail/Lottery* version, Fhlmc 2571 "GG," is also a 2.7-year average life that will return principal by lottery in increments of \$1,000. Both classes carry the same coupon, collateral, estimated average life and principal payment windows. While the market price can fluctuate as market conditions change, the principal amount of a lottery bond will always be the same as the face amount.

Principal redemption in \$1,000 increments allows an investor to determine at a glance, principal remaining on the investment. Compare for example a \$15,000 investment in both a lottery bond and a traditional pro-rata bond.

Comparison	Lottery Bond	Pro-rata Bond
Original Principal (Face) Amount	\$15,000	\$15,000
New Face Amount - if \$5,000 paid down	\$10,000	\$15,000
Factor	1.000	0.667
New Principal Amount (Face amount x factor x price)	\$10,000	\$10,000

In the case of the lottery bond, the face amount was reduced. The face amount on the pro-rata bond remained at the original \$15,000, but the factor (which represents the percentage of principal which remains) is reduced to 0.667. The end result is the same.

A national network of securities dealers (including Janney Montgomery Scott LLC) sells, trades and makes markets in mortgage securities including Retail/Lottery bonds, providing investors with strong liquidity. Although most mortgage-bond owners plan to hold until maturity, it is important to know that they can be sold at any time. The sale price is always dependent on current interest rates, therefore the value can be either greater or less than the original purchase price.

Also keep in mind that the actual weighted average life of the investment may vary from one holder to the next as principal is pre-paid at different times and in different amounts.

Chris Ade
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