

## The Relative Value of Hybrids

The Hybrid ARM market offers investors a diverse set of investment opportunities. Investors can use hybrids to take advantage of a view on changes in the location of the curve, the shape of the curve, volatility, the TED basis, and prepayments- or to buy and sell caps and floors with various strikes. The diverse risk exposures available within hybrid ARMS and the compound bond and option features inherent in them make assessing their relative value more difficult, however. This is particularly true in the current, dynamic interest rate environment. The recent 150 basis point flattening of the yield curve is likely to reveal numerous new and interesting performance aspects of hybrid ARMS as their origination and prepayment behavior becomes better known.

To effectively take advantage of investment opportunities in the hybrid ARM market, competent OAS analysis is critical. The results of a current OAS analysis are presented in the table below. It reveals several interesting facts about the risk and relative value of ARMS and Hybrids in the current environment.

	<u>1 YR CMT</u>	<u>3/1</u>	<u>5/1 Seasoned</u>	<u>5/1 - 2/2/6</u>	<u>5/1 - 5/2/6</u>	<u>7/1</u>	<u>10/1</u>
OAS Maturity	(9)	34	18	42	33	20	23
OAS Balloon		(2)	11	38	26	15	20
FC Maturity	4	56	51	78	68	75	88
FC Balloon		9	27	63	54	65	83
Eff Duration	1.73	1.63	1.77	2.08	1.92	2.11	2.44
Mod Duration	2.80	2.19	2.26	2.48	2.33	2.48	2.42
Eff Convexity	(0.32)	(0.58)	(0.71)	(0.84)	(0.87)	(1.41)	(1.36)

- 1 YR CMT ARMS have the lowest OAS and appear to offer the worst relative value.
- 5/1 hybrids with 2/2/6 cap structure have the highest OAS followed by 5/1 hybrids with the 5/2/6 cap structure. These securities appear to offer the best relative value.
- The duration and convexity of 5/1 hybrids with a 2/2/6 cap structure and a 5/2/6 cap structure are very similar. The differences in caps between these two securities do not create material price risk differences between these ARMS in the current environment.
- The duration and convexity of 5/1 hybrids are not substantially greater than that of 3/1 hybrids in the current environment while the OAS difference strongly favors the 5/1 hybrids.
- The nearby balloon inherent in the 3/1 hybrid poses increased call risk to 3/1 investors. This can be seen by comparing the OAS to maturity and the OAS to balloon for the ARMS.
- The OAS to maturity and balloon are very similar for the 5/1 hybrids. This reflects the fact that the balloon payment is relatively far in the future for the 5/1 hybrids and indicates that the tail is not the primary contributor to the OAS of the 5/1 ARMs.