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The Month In Review

May 2006

What's New?

Compass is excited to welcome Kobie Burrell as a contract financial engineer. Kobie brings his considerable talent and experience to Compass and will be working on stratification, reporting engine and cash flow initiatives. Kobie was most recently with IPS-Sendero where he was a lead engineer and holds a Computer Science degree from MIT.

New in CompassPoint™!

Compass is pleased to report its recent development progress in CompassPoint™, including:

- Report enhancements including Day Summary Change and Best Execution Change.
- Ability to define multiple pullthrough models for the same loans, associated logic to use separate models for accounting and coverage purposes.
- Ability to derive and view aggregate statistics on a row level within text and numeric histograms in stratification tool.
- ADCO prepayment model integration.
- Expansion of 3-factor prepayment model to expand number of vector points.
- Additional hedge assets including amortizing swaps, caps, and floors.
- Expanded volatility surface
- Structured cash flow development including ability to define structure definitions accessible across valuation methods, DM discounting, par floater bonds, definition of pro-rata/sequential windows and forward rate curve derivation/discounting.
- Continued development and testing in loan level fallout and hedge cost analytics

CompassPoint™ features and capabilities reflect the business needs as defined and requested by its users. For additional information on new features or to submit suggestions and requests, please contact Rob Kessel at 415-925-2812 or e-mail at rkessel@compass-analytics.com.

Topic of the Month: Targeted Profit Margin Adjustments

In an environment where higher mortgage rates are putting pressure on production volumes, it becomes increasingly important to have the necessary information available to make sound pricing decisions and stay competitive. One typical strategy used to combat decreasing lock volumes is to "sharpen the pencil" and trim back expected profit margins. Just as many lenders increase their expected profit margins when rates are low and volumes are high, lenders may choose to tighten margins when volumes slip to help maintain market share and keep the operations departments working at a reasonable clip. Profit margins can be tightened across the board (i.e. the expected margin passed-through on the ratesheet would be uniformly cut on each product and/or note rate). But a more targeted strategy, one that may produce a better combination of volume and margin, requires segmenting the pipeline and cutting those margins that would be expected to produce the best overall results.

In looking at the margins for a given product, for instance, it may be more beneficial in total to target cuts in specific note rates, rather than spread the margin reduction evenly across all note rates. For example, many lenders face rate surveys (either structured, 3rd-party surveys or impromptu surveys done by their production sources) and these surveys often target specific note rates for ease of comparison. Let's assume that for a given product type, a widely used rate survey is currently ranking lenders on the price of their 6.50% note rate. Although a lender's ratesheet may be very competitive on note rates of 6.25% or lower and note rates of 6.75% or higher, if the lender is being compared solely on their 6.50% price, they may appear to fall short of the competition and the rates that they're competitive on may go unnoticed. To alleviate this situation, the lender may choose to cut their expected profit margin on 6.50% notes and, hence, improve their price on the rate that their clients are focusing on.

The difficulty and danger in trimming expected profit margins, especially on a targeted basis, arises when the secondary marketing department does not have a clear picture of the effect of the margin change. To make an informed decision on the expected effect to the overall profit margin and loan volume, secondary marketing needs accurate data on current, actual profit margins, segregated by the factors defining the targeted change, plus reasonable assumptions as to the expected change in lock volume across defined factors once the margin change is in place. The chart below shows a simplified example of how a targeted, note-rate specific margin adjustment might look.

Note Rate	Current Margin (bps)	Current Volume (M)	Current Margin ($)	New Margin (bps)	New Volume (M)	New Margin ($)
6.25	50.0	10.0	$ 50,000	50.0	10.0	$ 50,000
6.50	50.0	10.0	$ 50,000	25.0	10.0	$ 25,000
6.75	50.0	20.0	$ 100,000	50.0	20.0	$ 100,000
	50.0	**40.0**	**$ 200,000**	**43.8**	**40.0**	**$ 175,000**

In this example, the lender was making a flat 50 bps on each note rate, which generated $200,000 in revenue on 40MM in closed volume. The lender decides to target the 6.50% note rate and lower the margin there to 25 bps. If no assumption is made as to a change in volume across notes rates, then the 25 basis tightening on the 6.50% would lower the average margin to 43.8 bps and lower the revenue on the 40MM to $175,000.

In contrast, the chart below shows a more likely scenario where volume on the targeted note rate would increase due to the improved pricing.

Note Rate	Current Margin (bps)	Current Volume (M)	Current Margin ($)	New Margin (bps)	New Volume (M)	New Margin ($)
6.25	50.0	10.0	$ 50,000	50.0	10.0	$ 50,000
6.50	50.0	10.0	$ 50,000	25.0	30.0	$ 75,000
6.75	50.0	20.0	$ 100,000	50.0	20.0	$ 100,000
	50.0	**40.0**	**$ 200,000**	**37.5**	**60.0**	**$ 225,000**

In this example, the lender assumes that the 25 bps improvement on the 6.50% note will triple volume on that note to 30MM, while leaving volume on the other two note rates (where they were already competitive) the same. This boosts total volume to 60MM but effectively lowers the average margin across notes even further, to 37.5 bps. Even with the lower average margin, the lender still makes more total revenue ($225,000) as the volume pick-up more than makes up for the drop in average margin. But, it's important to note that all scenarios, even those that do not contemplate a change in margins, require an accurate picture of the profit margins, within each segment and across the pipeline. Making any pricing decision without a clear understanding of the actual profit margins involved can be costly. You can't make up for a zero or negative margin through increased volume.

This describes just one simple example and many other types of targeted adjustments (by product, production source, lock period, etc.) can be made. In each case, the analysis would be similar: define your current margins, segregated by the targeted attribute, develop assumptions for the effect on production volumes across the attributes, and model the effect of the proposed change on average margin and expected revenue. By using a more targeted approach to margins and margin changes, the lender can maximize their competitive position and keep volume and revenue flowing. *–Lindsay Hill*

Market Update

The bond sell-off that began in January continued into May as strong economies at home and abroad helped push yields, and stock prices, higher. By the end of the first week in May, the 10-yr treasury yield moved into territory not seen in a few years as it climbed to 5.19%. Economic reports over the last few weeks have tended to surprise to the upside and confusion over the likely path of the Fed helped increase daily volatility.

Release of the Fed minutes from the previous meeting showed the concern rising in the committee over the possibility of tightening too much. Chairman Bernanke created a stir when he stated that the Fed might choose to take a "pause" in the current tightening to allow the economy to more fully-absorb the effects of the previous increases. He further churned the markets by subsequently stating that the market may have misinterpreted his "pause" comment. It's clear that Bernanke and the markets still have some feeling-out to do with regards to the way the chairman delivers his opinions and the reactions caused thereby.

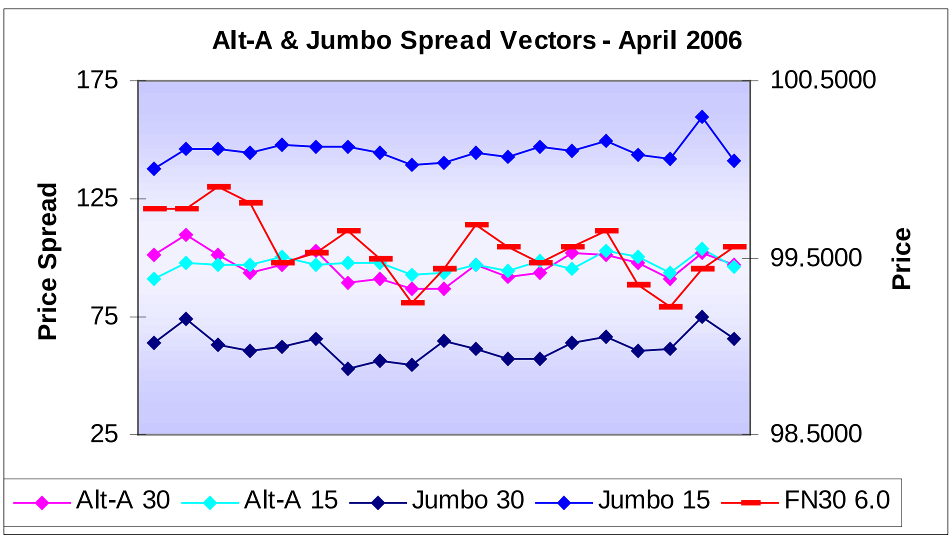
Despite several strong economic releases throughout the month, those that hope and/or expect an upcoming pause in the Fed tightening cycle were likely cheering the slow job growth report issued for April. Non-farm payrolls grew by only 138,000 vs. an expectation of about 200,000 and March and February growth numbers were revised lower. This might have been enough to produce a fairly significant rally had it not been for the wage growth number that was about double the expected increase. The net effect for the week of the unemployment report was for yields to again close higher.

The market still has another .25% Fed Funds increase priced in for the May meeting (which will be history by the time this article is distributed) but from there, the picture remains cloudy. Bernanke has not been particularly clear on his thoughts to this point, but that's not entirely his fault. It's a tough call to make when the economy looks strong but inflation remains tame. If anything is clear, it's that the Fed would like to keep its options open. *-Lindsay Hill*

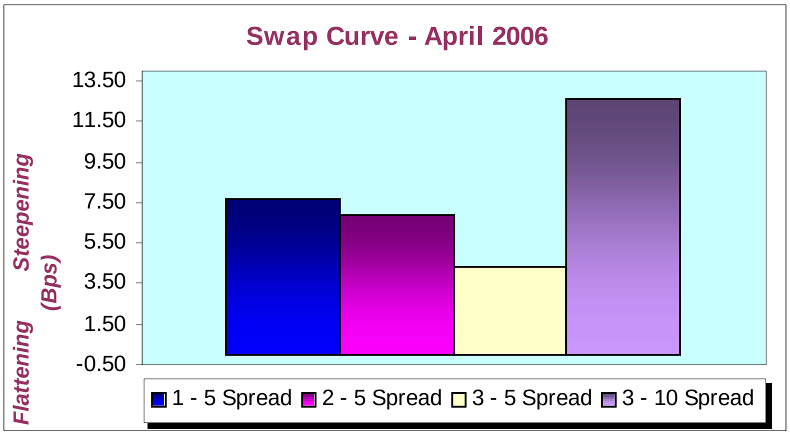
Alt A and Jumbo Spreads

The MBS volatility observed in March continued through April, although Alt-A and Jumbo spreads remained relatively stable. The first big move of the month occurred on the release of the NFP number, which came in stronger than expected. Although the market sold off, as much as 35 bps on FN30 6.0's, spreads only moderately moved. This non-reactive behavior continued throughout the month with an average daily change of 4 bps, despite the volatile market. The largest move in spreads occurred on the second to last day of the month as the market rallied on Fed Chairman Bernanke's speech, signaling that the Fed may take a pause at 5%. All spreads increased and then reversed direction the following day, bringing them back to the level maintained throughout the month of April.

Compass's valuation of the Alt-A and Jumbo Fixed bulks in April derived prices within a 25 bp average range from the winning bids. Our expected valuations came in very close to the covers, perhaps indicative of stronger appetites for the investors that won. The spread between investor bids continued to decrease in April; the largest variance observed was 129 bps, one point less than the largest observed in March. *-Vimi Vasudeva*



Hybrid Arm Hedge Analysis



April began relatively quiet for MBS with little news moving the market early in the week. Fed President Hoenig prompted a small rally Thursday with his suggestion that the Fed may be near the “upper end” of the neutral range for rates, where policy is neither spurring nor hindering economic growth. Friday’s stronger than expected NFP release and slight drop in unemployment gave rise to fear of a tighter labor market which led to a 34 bps sell off. Swap spreads steepened over the course of the week, with the 3-10 spread widening by 5 bps and the rest of the curve by an average of 3 bps.

In the subsequent holiday shortened week, MBS drifted higher and swap spreads tightened a few bps through Tuesday with no data releases. The market and spreads reversed course Wednesday as International Trade and Treasury Budget data revealed a narrowed trade gap though an expanded budget deficit. Strong Retail Sales data on Thursday forced the market lower and swap spreads wider for a second day. The market lost 22 bps with swap spreads steepening across the curve once again, led wider by the 1-5 spread at about 2 bps.

The following week began with the market rallying on benign PPI numbers and the release of the March 28 Fed minutes, which many investors saw as a signal the rate hike cycle may end after the May 10 meeting. Through Tuesday, the market had rallied 44 bps, though swap spreads were only slightly tighter. Over the next two days MBS gave up 21 bps on stronger than expected Core CPI data. MBS gained 31 bps over the course of the week, what would be the only weekly gain in April. The 1-5 swap spread tightened 2 bps, the only weekly tightening in April, while the remainder of the curve was wider, though less than ½ bp on average.

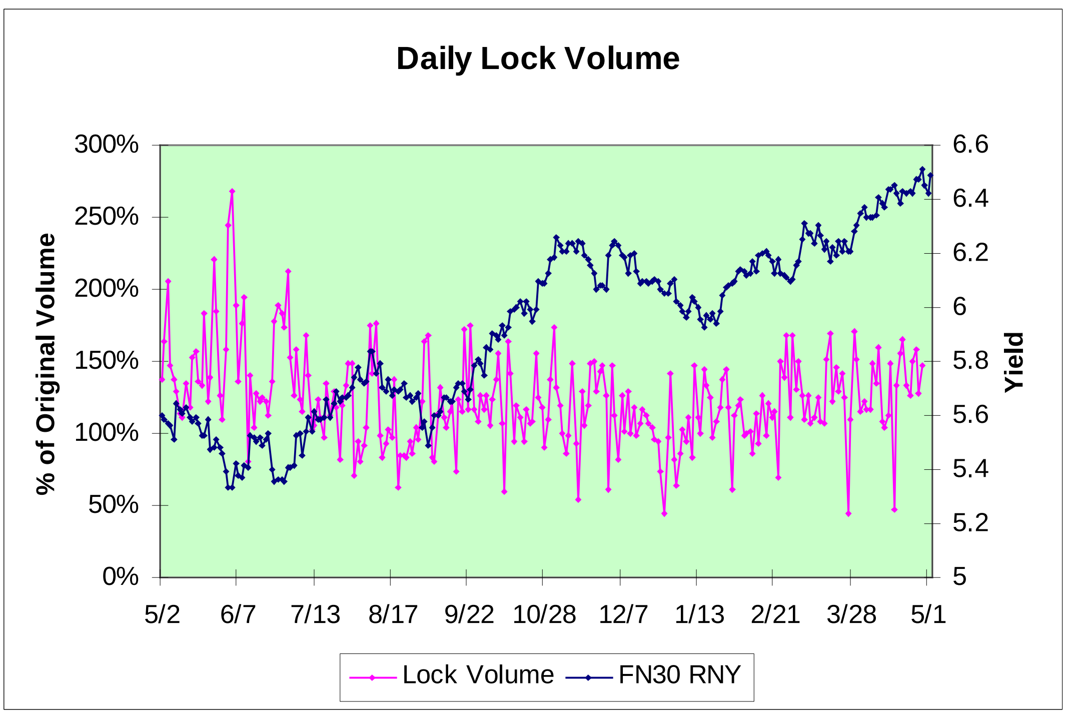
After moving higher with no data on the final Monday in April, strong economic releases, including Consumer Confidence and Home Sales Data, ignited a two day sell off – the market lost 44 bps with swaps spreads mixed. Bernanke’s testimony on Thursday in front of the Joint Economic Committee interrupted the market’s slide as he commented on the possibility of a pause in rate hikes. Mixed data on Friday coupled with Bernanke’s testimony helped the market recover its early losses to finish unchanged for the week. Swap spreads were wider across the curve once again, led by the 3-10 portion at 5.5 bps, as long term yield gains outpaced short maturity yields.

As seen in the graph, the swap curve steepened overall last month, with the 1-5 and 3-10 portions widening most notably. The market lost 28 bps and the 10 year swap led yields higher at 18 bps and yield gains increased with longer maturities, making for a more normal curve.

At April month end, the Eurodollar Future hedge outperformed the Dwarf hedge by an average of 10 bps with all studies finishing in positive territory and the 5/6 hedges exhibiting the best performance. *–Virgil Caselli*

Month Ending Apr 28 2005	Hedge Performance ED (Bps)	Dwarf (Bps)
3/6 Arm	17	14
5/6 Arm	45	34
7/6 Arm	30	13

Production Index



As observed in the previous 3 months, April production again trended upward in the face of climbing interest rates. Average volume for the month was 131% of our base volume (vs. 126% in March) ranging from a low of 48% to a high of 165%. The average yield on the FN30 RNY was 6.41% (vs. 6.24% in March) ranging from a low of 6.33% to a high of 6.51%. *-Bob Gundel*