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The Month In Review

March 2005

What's New At Compass?

Compass welcomes Bob Gundel as our new Trading Assistant. Bob joins us most recently from Fisher Investments, where he worked as an Inside Sales Rep. Prior to Fisher, Bob worked as an Options Floor Broker on the Pacific Stock Exchange for Botta Capital Management L.L.C. He graduated from Saint Mary's college with a Business Management degree.

On March 12th, we moved into our new location, please update your records with our new contact information:

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New in CompassPoint™!

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

- * Loan Level Hedge Cost Analysis
- * Enhanced Historical Fallout and Profitability Analysis and Automation
- * Daily Month-End FAS133 Forecasts
- * Enhanced Hedge Bucketing Control and Reporting

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.

Market Update

It seemingly took forever, but the higher yields everyone's been assuming were right around the corner have begun to appear. As we head into the middle of March, the treasury curve has finally shown some steepening and the 10-yr yield has moved above 4.50% for the first time in seven months. There are still some things working in the favor of bonds, but the long end of the curve has moved fairly decisively outside of the range that held strong since September.

In the early part of February, bonds were poised to test the low yields of the recent range. On the heels of the January employment report released on February 4th, bond and mortgage prices shot higher and the



yield curve flattened once again. With job growth still coming in below expectations, many began looking for the Fed to halt the increases, at least temporarily. The curve flattening that had dominated trading throughout most of the last year was continuing. But, as had been the case in the prior move below 4.00% on the 10-yr, the move was very short-lived. Yields moved up quickly and the 10-yr yield rose to 4.25% within about a week of testing the lows.

Then, along came the number bulls and flatteners feared, a high core reading on the PPI. The market had done a good job of shrugging off evidence of a slowly improving economy with the conviction that inflation was still tough to find. Greenspan, in his semi-annual testimony to Congress, also took the opportunity to voice dissatisfaction with the flat curve and the seeming inability of the Fed to affect long-term rates. Asked and answered. The curve began steepening and the spread between the 2- and 10-yr notes moved from 10 bps to 83 bps in the course of a week (still nowhere near the 243 bps seen a year ago before the Fed started tightening).

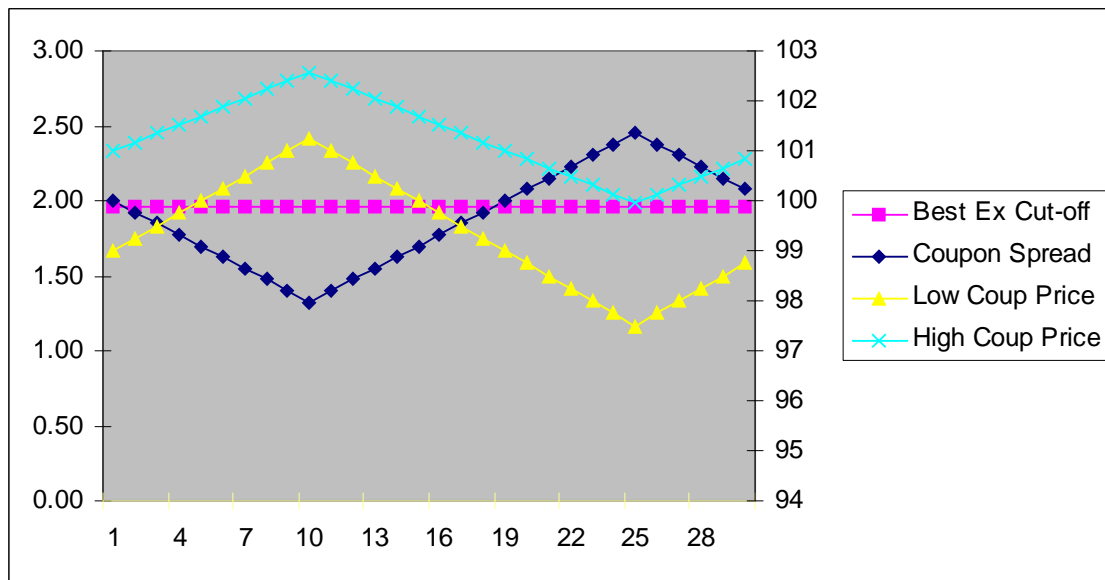
The February employment report showed some strength, even though the unemployment rate rose to 5.4% from 5.2%. Bonds rallied that day on what was probably more of a technical move than one driven by the report itself. This became evident when the market resumed its slide the following week. The last month has seen a test of the sub-4.00% 10-yr and a break out past the 4.50% mark. With the old range out of the way for the time being, it seems that the path of least resistance is towards higher rates.

Topic of the Month - Coupon Execution and Swap Opportunities

As we've all seen several times in recent months, price movements in the MBS market can have the effect of the proper delivery coupon for various note rates. For example, note rates in the 30-yr sector such as 5.750 and 5.875 may see their best execution bounce back and forth between the 5.00 and 5.50 coupons, depending on the current buyup/buydown multiples and the price spread between the two coupons.

Given that durations (or price sensitivity for a movement in rates) are generally higher for lower MBS coupons, a 5.00 coupon security will usually improve or worsen in price faster than a 5.50 coupon. On days when the 5.50 coupon is up 8/32 in price, we may see the 5.00 coupon up 10/32 and when the 5.50 coupon is down in price, the 5.00 coupon is usually down further. The relatively higher volatility of the 5.00 coupon affects the price spread between the coupons as the market moves. Agency buyup/buydown multiples are formulated to, in part, mimic the expected relative price movements of different coupons and note rates. But, since the agencies only update their grids once or twice per month, execution opportunities and opportunities to adjust coverage may arise and change throughout the month.

The chart below describes a hypothetical market across 30 days in which prices (as seen by the light-blue and yellow lines on the right-hand axis) improve during the first part of the month, drop through the middle of the month, and then improve somewhat at the end. Using a static duration ratio of 1.30 for the 5.00 coupon vs. the 5.50 (the 5.00 price moving at 130% of the 5.50 price in either direction) we can see that the spread in prices between the two coupons (dark-blue line, left axis) decreases as prices improve and increases as prices worsen. Typically, the duration ratio between the two coupons would also move slightly as prices change, but this describes the general pattern one would expect.



In this example, the pink line (left axis) shows the cut-off between where a 5.750 note would be best delivered into 5.00 vs. a 5.50 coupon given the following assumptions:

Gfee	=	.21
Servicing	=	.25
B-Up Mult	=	3.00
B-Down Mult	=	5.20

Thus, whenever the price spread between the two coupons is tighter than approximately 1.96 points (when the dark-blue line is below the pink line) the 5.750 note should be delivered into the 5.00 coupon and whenever the spread is wider than 1.96 points, the note should be delivered into a 5.50 coupon.

If we assume that a group of 5.750 notes were locked at the beginning of the period, and that we wanted to cover those locks with the expected delivery coupon, we would have initially taken coverage in the 5.50 coupon since the execution was slightly better to that coupon at the beginning. As prices began to rise, and assuming no change to the buyup/buydown multiples, the best execution quickly switches to the 5.00 coupon. This creates an opportunity to swap coupons at an advantageous time. Without altering our hedge strategy of covering loans with their expected delivery coupon, we can swap to the lower coupon and take advantage of the relative price improvement in the 5.00 coupon, which we will now sell, vs. the 5.50 coupon, which we will now buy. Later in the month, we can reverse this trade, again at an advantageous time when we can buy back the 5.00 coupon that has fallen faster than then 5.50 coupon that we now need to sell. In each case, we would swap the coupons at a time when the execution difference was as least sufficient to cover the transaction cost.

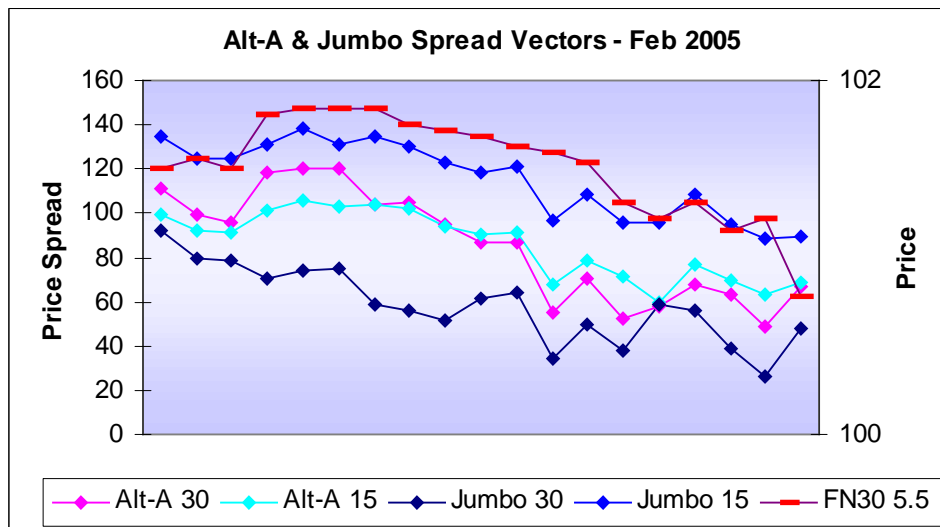
Ultimately, in this example, the spread between the two coupons finished nearly where it began but two opportunities to swap between coupons were created by the market. In both cases, the swaps would have served two purposes. One, in keeping our coverage in line with our best execution, we provide for security delivery to the best execution coupon and we maintain a closer duration match between our loans and our coverage. Two, we take advantage of buyup/buydown grids that do not change as quickly as the market, thus moving our coverage when the trade is in our favor.



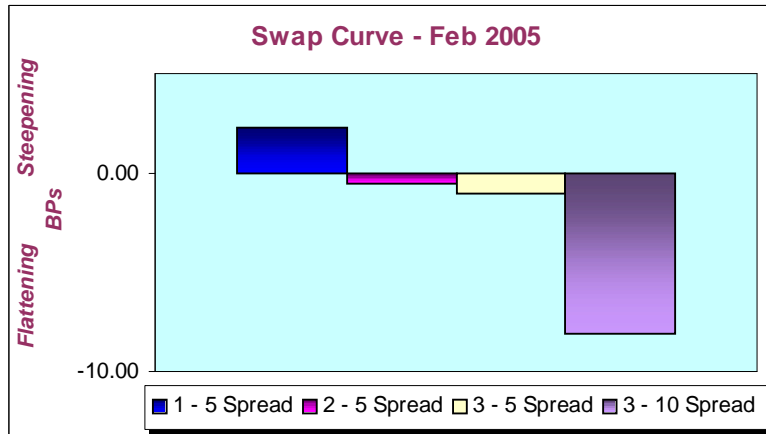
Alt A and Jumbo Spreads

Alt-A and Jumbo spreads shadowed the market moves this month, once again delineating the trend of widening spreads as the market rallies, and tightening spreads as the market falls off. Volatility was relatively slow in the first half of the month, with spreads moving by an average of 5 bps day over day. Volatility picked up in the third week of February as prices began to fall, and spreads bounced around within a 20 bp range.

Compass valued four Alt-A and Jumbo Fixed bulk bids in January, for which our valuation derived prices within an average of 37 bps. The range of bids from investors was as high as 125 bps for one, which is similar to what we have observed in the past. What is out of the ordinary, however, is that one bulk only had a 27 bp range between the highest and lowest bids, the lowest variance we have seen in such type of bulks. If this pattern continues in future bulk bids, it could be indicative of a more conforming perspective on how these products are valued.



Hybrid Arm Hedge Analysis



Month Ending	Hedge Performance	
	ED (Bps)	Dwarf (Bps)
Feb 28 2005		
3/1 Arm	6	(11)
5/1 Arm	6	(4)
7/1 Arm	27	4

After months of relentless flattening, the curve finally started to take on a new shape in February. The front end of the curve actually steepened by 2 bps, and the 2-5 and 3-5 spreads flattened marginally, only by approximately 1 bp (see Swap Curve Spreads). The belly of the curve continued to flatten, but at a decreasing rate compared to previous months in which it flattened by over 20 bps. It is interesting to observe that the Eurodollar hedge outperformed the Dwarfs on all hybrids in such an environment where the flattening was less aggressive and steepening started to creep in. Not only did the Eurodollars outperform the Dwarfs, they actually produced a hedge gain, while Dwarfs produced a loss on two of the three studies.

Production Index

February lock volume got off to an average start, and remained solid through the month with only three weak days - two coinciding with the Presidents Day holiday and the third with the rate surge on February 28th. We did not see the wild swings in volume we had witnessed with the past few months and most of the volume came in above average. The FN30 RNY displayed an average yield of 5.42%, a bit lower than last month, but broke through 5.6% level on the last day of February. Yield showed a range of 5.33% to 5.64%.

