

Fixed Income Insight October 26, 2004

Commercial Mortgage Backed Securities

Commercial mortgage backed securities (CMBS) are bonds that have been collateralized by a pool of commercial real estate mortgages. All of the principal and interest from the mortgages flow to bondholders over the life of the bonds.

The first CMBS pools were created following the example of the Resolution Trust Corporation, which securitized existing loans of failed S&Ls in the late 1980s. The securitization of new loans first began in the early 1990s. In 1991 CMBS issuance totaled \$8 billion, but it has since grown to a high of \$106 billion in 2003, with total historical issuance of more than \$500 billion. In terms of creditworthiness, CMBS bonds have an impressive track record: a recent Fitch report (which takes into account both investment grade and below investment grade securities) shows that the cumulative overall CMBS default rate during the years 1990-2003 was 0.2% vs. 11% for corporate bonds.

Typically CMBS trusts range in size from just under, to well over, \$1 billion. The mortgages in a pool usually number between 100 and 200. CMBS deals are often sold on the basis of the composition of the ten largest loans in the pool. These loans frequently comprise 40-50% of the total pool of mortgages, and some are shadow rated investment grade by the bond rating agencies.

A number of different real estate sectors are represented in CMBS offerings: retail, multi-family, office, industrial, hotel, self storage facilities, manufactured housing parks and health care/senior housing. The three most heavily weighted sectors in many CMBS trusts are retail, multi-family and office.

The structure of CMBS deals offers several tranches, each with its own distinct level of security. The tranches range from AAA-rated to B-rated, as well as non-rated. The largest portion of the typical deal is rated AAA. Each tranche is given credit support by lower rated tranches—a so-called “subordination level.” For example, if the AAA tranche subordination level is 12%, a trust would have to sustain a 12% default hit for these bonds to feel an impact on bond principal (currently, no AAA-rated CMBS bonds have ever been so affected). Lower rated tranches cushion the impact of credit problems/defaults that develop in the mortgages making up the trust. Buyers of below investment grade tranches are key players in these transactions—they are responsible for workouts of troubled properties/mortgages.

According to Bloomberg, CMBS spreads to US Treasuries over the one year period 8/16/03-8/16/04 ranged as follows for various tranches (see table at right).

| QUALITY | RANGE |
|----------------|--------------|
| AAA 5-year | 63-87 |
| AAA 10-year | 64-89 |
| AA | 71-98 |
| A | 79-106 |
| BBB | 115-160 |
| BBB- | 160-220 |
| BB | 403-440 |
| B | 900-993 |



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Guiding Portfolio Strategies

For investors familiar with Real Estate Investment Trusts (REITs), the following points of comparison between REIT bonds and CMBS may be helpful:

- **Portfolio management:**
Inactive for CMBS; active for REITs.
- **Number of properties in individual portfolios:**
For CMBS, 100-200; for larger REITs, up to 1,000 and more.
- **Portfolio diversification:**
A number of different real estate sectors are represented in CMBS trusts; many REIT portfolios focus on one sector only.
- **Security:**
Specific properties/mortgages in portfolios secure CMBS bonds; for REITs, corporate guarantees/covenants of REIT firms secure bonds.
- **Leverage:**
Average LTV about 70% for CMBS; average LTV about 53% for REITs.
- **Bond ratings:**
Ratings for CMBS tranches range from AAA to B and NR; most REIT bonds are rated from BBB- to BBB+.
- **Event risk:**
For CMBS, minimal for highly rate tranches, moderate to high for BBB and below; for REITs, all bondholders share in any losses.
- **Size of market:**
For CMBS, \$500 billion total market capitalization—but only \$25 billion for BBB-rated tranches; for REIT bonds, \$60 billion.
- **Lehman Aggregate Index weighting as of 9/8/04:**
CMBS (including bonds across all rating categories): 2.91%; REITs: 0.28%.
- **Spreads to Treasuries:**
During the years 1998-2003 the range was 130-325 for CMBS BBB-rated tranches; for the same period the spread was 120-320 for REIT bonds.

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