BMO Canadian MBS Index ETF (ZMBS)

Mortgage-backed securities: Guaranteed by the Canadian government

ZMBS
Mgmt Fee: 0.15%
Risk Rating: Low

ZMBS invests in Canadian National Housing Act Mortgage Backed Securities (NHA MBS 975 Pools) which make it an ideal investment for those looking for defensive income.

- AAA Rated with term to maturity greater than one year
- Minimum amount outstanding of $100 million
- Rebalanced on a monthly basis

Why Mortgage-Backed Securities?

Mortgage-Backed Securities ("MBS") are fixed-rate investments that represent an ownership interest in a pool of many mortgages. Every month investors receive a proportional share of the interest and principal payments associated with those mortgages. The mortgage pool is securitized, meaning that the mortgages are packaged into a credit-enhanced investment and sold to investors through investment dealers and banks.

Fully guaranteed by CMHC

- NHA MBS are fully guaranteed by CMHC in Canada, both principal and interest payments.
- Unlike savings accounts and GICs, there is no limit to the CMHC guarantee on NHA MBS.

Defensive Income

- Yield pick up over federal bonds while maintaining a AAA rating.

Highly Liquid

- No Lock Up Period.
- ETF structure allows investors the efficiency of a one ticket solution to access this OTC market segment.

Effective laddering

- As mortgage pools reach one year to maturity the proceeds are rolled into new five year to maturity pools.
- Effectively the portfolio will roll on an annual basis.

A note on prepayment risk:

Mortgage-backed securities are a pool of mortgages which ensures that prepayment risk is diversified.

There are two basic types of NHA MBS: non-prepayable and prepayable pools. In non-prepayable pools, the principal on the underlying mortgages can only be repaid according to the original amortization schedule. In prepayable pools mortgagors are allowed to make unscheduled principal payments under certain conditions. Thus, in addition to scheduled principal and interest, investors holding prepayable NHA MBS may also receive unscheduled principal and, in some cases, penalty interest charged to mortgagors who make early prepayments. In addition, investors will not have to deal with the nuances of the amortization rates of individual MBS pools as this will all take place within the ETF.

Dispelling fears around MBS

MBS were a central factor in the US subprime mortgage crisis. With the rapid increase in home prices, lower interest rates, the rise of speculative buyers and growing demand for MBS, the banks lowered their lending standards. MBS credit ratings did not drop as the quality of mortgages declined. In 2006 housing prices peaked and subprime borrowers began to default. Further amplifying the problem was synthetic CDOs which were betting on the performance of these mortgages. MBS and CDOs (based on pools of these mortgages) were vastly overvalued making it difficult for investors to offload them and in time causing the Government to step in.

How is Canada different?

In the NHA MBS market all MBS are fully insured by CMHC, both principal and interest with no limit to coverage. From the credit crisis, Canadian mortgage standards were generally more stringent than in the US with subprime mortgages, meaning that the quality of mortgage pools has been higher.