



Investor's Guide to Collateralized Mortgage Obligations (CMOs)

In accordance with FINRA Rule 2216(b)(2)

July 2026

Introduction

In accordance with FINRA Rule 2216(b)(2), this guide includes the following information:

(A) a discussion of:

(i) characteristics and risks of CMOs including credit quality, prepayment rates and average lives, interest rates (including their effect on value and prepayment rates), tax considerations, minimum investments, transaction costs and liquidity;

(ii) the structure of a CMO, including the various types of tranches that may be issued and the rights and risks pertaining to each (including the fact that two CMOs with the same underlying collateral may be prepaid at different rates and may have different price volatility); and

(iii) the relationship between mortgage loans and mortgage securities;

(B) questions an investor should ask before investing; and

(C) a glossary of terms.

This educational brochure is intended for informational purposes only and should not be considered investment, legal, tax or accounting advice.

Contents

- 01 Characteristics and Risks of CMOs** _____ 4
 - The Relationship Between Mortgage Loans and Mortgage Securities _____ 5
 - Characteristics and Risks _____ 6
 - CMO Structures _____ 8
 - Tax Considerations, Minimum Investments, Transaction Costs and Liquidity 11
- 02 Questions an Investor Should Ask Before Investing** _____ 12
- 03 Glossary of Terms** _____ 14

01

SECTION

Characteristics and Risks of CMOs

Characteristics and Risks of CMOs

Collateralized Mortgage Obligations (CMOs) are multi-class debt instruments backed by a pool of mortgage pass-through securities or mortgage loans, including real estate mortgage investment conduits (REMICs).

Before investing in a CMO, it is important to understand how these securities work and whether they are appropriate for your financial situation, risk tolerance, time horizon and investment objectives.

The Relationship Between Mortgage Loans and Mortgage Securities

The creation of a CMO begins with mortgage loans issued by a bank, mortgage companies and other originators to finance a borrower’s home or other real estate.

These mortgage loans are purchased from the lending institutions and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.

When borrowers make monthly mortgage payments, the principal and interest collected from those mortgages are distributed to the investors of the CMO. The principal and interest payments made on the pool of mortgage loans are distributed to the different classes of securities, known as tranches, according to a priority of payments. Each tranche will have its own payment schedule and risk profile. Each tranche may have different principal balances, coupon rates, prepayment risks and maturity dates. These tranches allow investors to choose a cash flow and risk profile that suits their investment strategy.

Individuals obtain mortgage loans to purchase real estate	Mortgage loans are pooled together by financial institutions	The pooled mortgages are securitized into mortgage-backed securities (MBS)	CMOs are structured from these MBS by allocating cash flows among different tranches	Investors receive payments based on the performance of the underlying mortgage loans
---	--	--	--	--

Characteristics and Risks of CMOs

CMOs offer advantages to investors and carry certain risks. While CMOs have stated final maturity dates at which principal must be returned, they can make principal payments throughout the life of the security. The timing of these payments may vary significantly depending on interest rate changes.

Credit Quality

Agency CMOs

Most CMOs are issued by governmental agencies (Ginnie Mae) or government sponsored enterprises (e.g. Fannie Mae, Freddie Mac) which generally guarantee timely payment of principal and interest regardless of whether the payments have been collected from borrowers. Ginnie Mae is a government-owned corporation and is backed by the “full faith and credit” of the US Government. Government Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac have federal charters and timely payment of principal and interest are backed by the GSE itself. The GSEs require rigorous underwriting standards to assess loan quality and mitigate risk to investors.

Private Label CMOs

CMOs may also be issued by non-governmental or private issuers. These Private Label CMOs typically consist of mortgage loans that do not qualify for agency underwriting due to loan size, credit factors or other reasons. Private label CMOs are the sole obligation of the issuer and are not guaranteed by any of the GSEs or the US Government. Private-label CMOs may be rated by independent credit agencies based on their structure, issuer, collateral, or other factors.

*Accordingly, private label CMOs tend to have a higher **credit risk** than Agency CMOs because they don't have an implied or explicit government guarantee.*

Prepayment Rates and Average Lives

Principal payments on CMOs arise from both the regular amortization of the underlying mortgages and from prepayments of those mortgages due to sales or refinancings or when a borrower otherwise pre-pays their loan. The Average Life is the average amount of time required for every dollar of

unpaid principal to be repaid, a weighted-estimate of time it will take for the tranche to be paid back in full.

The speed at which the mortgage collateral prepays affects the maturity and average life of all the tranches of a CMO as well as the price/yield relationship. CMOs are priced using a given prepayment assumption which is based on recent historical prepayments as well as current prepayment projections for the collateral backing the CMO. The prepayment assumption is not guaranteed and changes in prepayment rates will have an impact on yield, total return, average life and projected final maturity. Faster prepayments shorten average life, decrease yield on a premium priced issue, and increase yield on a discount; slower prepayments have the opposite effect.

CMOs, like other interest-bearing investments, are affected by changes in interest rates.

*If interest rates fall, homeowners often refinance and pay off their mortgages early. This may result in the CMO paying back principal faster than expected. The investor then has principal to reinvest at lower market rates (because rates fell). This is **prepayment risk**.*

*If interest rates rise, homeowners are less likely to refinance or pay off a low-rate mortgage early. This may slow principal payments, extending the life of the CMO. CMO investors may face holding their investment for longer than anticipated, and the investor is then locked into a lower-yielding investment for longer. This is **extension risk**.*

The estimated yield and average life of a CMO considers prepayment assumptions that may or may not be met, and changes in payments may significantly affect yield and average life.

Two CMOs with the same underlying collateral may be prepaid at different rates and may have different price volatility.

CMO Structures

A wide variety of CMO securities with different cash flow and expected maturity characteristics exist with different investment objectives and risk tolerances.

Sequential Pay

In a sequential paying CMO, each tranche receives interest payments, and principal is paid to one class at a time in order of seniority. Once the first tranche is entirely matured, principal payments commence on the second tranche. Payments continue in this sequence until all tranches have been paid. Each tranche receives interest payments until the tranche's principal amount has been completely paid off. This is sometimes called a plain vanilla CMO.

Planned Amortization Class (PAC) and Companion (Support) Classes

***PAC tranches** establish a payment schedule designed to receive principal more predictably by using other tranches called **Companion Classes** to absorb variability in principal payments. If prepayments are faster than expected, companion classes take the “extra” principal (prepayment risk). If prepayments are slower than expected (extension risk), companion classes may go without principal for a period. This structure helps the PAC receive principal closer to the forecasted schedule. PACs use companion classes to reduce both prepayment and extension risk, making PAC classes more stable and subjecting Companion classes to volatility in payments.*

Target Amortization Class (TAC)

TAC tranches are like PACs, but they use only one prepayment rate and protect only against prepayment risk. The companion class absorbs principal that arrives faster than expected, making the TAC's principal payments more predictable when prepayments increase. However, TACs are still exposed to extension risk. If principal arrives slower than expected, the TAC's average life extends. TACs generally offer higher yields than PACs to compensate investors for this risk.

Z Tranches

***Z Tranches**, also known as accretion or accrual bonds, pay no interest before an extended period of time when the lockout period ends. It receives no cash*

payments until all senior tranches are fully retired. Instead, its coupon interest is accrued and added to the principal balance, compounding until payout begins. The accrued interest is taxable when credited, even though the investor receives no actual payment. Once all preceding tranches are completely paid off, the Z tranche finally begins receiving scheduled payments that include both accumulated principal and continuing interest. Due to its delayed payment timeline, a Z tranche has a very long expected average life (typically 18 to 22 years) and its exact lifespan is highly sensitive to interest rate changes and how quickly homeowners pay off their underlying mortgages. They are considered a risky tranche in a CMO with market values that can fluctuate widely.

Principal-Only (PO) and Interest Only (IO) Securities

PO tranches are structured so that investors receive only principal payments generated by the underlying collateral. POs usually sell at a deep discount from face value on the assumption that the purchaser will ultimately receive the entire face value through scheduled payments and prepayments. The market values of POs are extremely sensitive to prepayment rates, which, in turn, vary with interest rate changes. If interest rates are falling and prepayments accelerate, the value of the PO will increase. If rates rise and prepayments slow, the value of the PO will drop.

IO tranches result from the creation of POs; thus, CMOs with PO tranches also have IO tranches. IO securities sell at a deep discount to their equated principal amount - the principal balance used to calculate the amount of interest due. They have no face or par value and, as the notional principal amortizes and prepays, the IO cash-flow declines. Unlike POs, IOs increase in value when interest rates rise and prepayment rates slow; consequently, they are often used to "hedge" portfolios against interest rate risk. IO investors should be mindful that if prepayment rates are high, they may receive less cash back than they initially invested. Because of these risks, IOs are for sophisticated investors with a high-risk tolerance.

Floating Rate and Inverse Floater Tranches

Floating-rate tranches or "floaters" carry interest rates tied to a variable interest rate index, such as the Constant Maturity Treasury (CMT), or the Cost of Funds Index (COFI), subject to an upper limit or cap and sometimes

to a lower limit or "floor." The performance of these investments also depends on the way interest rate movements affect prepayment rates and average lives.

Inverse floaters (IFs) are structured to offset floating-rate tranches. Interest payments on IFs vary inversely with an index. Because IFs are more leveraged than other tranches, they have high price volatility as interest rates move. As the rate of the index drops, the interest rate on the IF rises at an accelerated pace. Conversely, rising rates cause an IF's interest payments to drop dramatically. Rising rates will lower interest payments and extend return of principal beyond the anticipated average life. As with other high-risk tranches, IFs are only suitable for sophisticated investors with a high-risk tolerance.

Residual Classes

In a CMO, a residual is a tranche that collects any cashflow remaining from the collateral after obligations to the other tranches have been met. They do not have a stated principal balance or a fixed coupon, returns are driven entirely by the difference between the interest collected on the underlying mortgages and the interest paid out to other bond classes, and they are highly volatile. If interest rates drop and there are high prepayments, the cash flow to residual holders can evaporate, leaving them with negative yields. They differ from other tranches in their tax characteristics, which can be more complex than other CMO tranches.

As you can see, while principal payments may be quite predictable for certain tranches or classes of a given CMO, other tranches of the same issue may be significantly less predictable. Certain tranches may be structured in such a way that, depending on interest rates and prepayments, investors are at substantial risk and may lose all or a substantial portion of their principal. The risks associated with these less predictable tranches may make them unsuitable for many retail investors.

Tax considerations, minimum investments, transaction costs and liquidity

Most CMOs are issued in the form of a Real Estate Mortgage Investment Conduit or REMIC. This structure of multiclass mortgage-backed securities has certain tax and accounting benefits for issuers and investors due to the Tax Reform Act of 1986. Please consult with a tax professional for tax considerations.

The minimum investment in a CMO may vary depending on the structure of the offering, however CMOs typically require a minimum investment of \$1000. The minimum investment amount is stated in the prospectus or offering circular for the CMO.

CMO transactions are executed over the counter and not on an exchange. Similar to other fixed income securities, transaction costs for CMOs primarily consist of bid-ask spreads (the difference between the highest price a buyer is willing to pay (bid) and the lowest price a seller is willing to accept (ask) for the security), dealer mark-ups/mark-downs, or broker commissions.

A secondary market may exist for many types of CMOs, the degree of liquidity depends on the characteristics of the individual CMO and can vary widely depending on economic and market conditions. The sale of a CMO in the secondary market, rather than waiting for the final payment, may cause a principal gain or loss as the securities may be worth more or less than their original face value.

02

SECTION

Questions an Investor Should Ask Before Investing

Questions an Investor Should Ask Before Investing

Prior to investing in a CMO, several factors should be considered in coordination with your Financial Adviser. Below are examples of some of the questions you should ask before investing.

Key questions

- *What is the type of tranche I am purchasing? Does it fit my risk tolerance and investment horizon?*
- *What is the estimated average life and final maturity? What assumptions were used to estimate average life, and how sensitive is it to prepayment changes?*
- *What is the estimate impact to estimated yield and average life if interest rates change?*
- *Are there guarantees or other credit enhancements associated with this CMO? What is the credit quality of the guarantor?*
- *What is the quality of the underlying collateral?*
- *What is the level of activity in the secondary market?*
- *What is the yield compared to other types of investments such as Treasuries, corporate and municipal bonds, adjusted for tax considerations?*

This list is not exhaustive but should give you an idea of the kinds of questions that should be answered. Your own investment priorities, risk tolerance and other individual factors should be considered.

03

SECTION

Glossary of Terms

Additional terms associated with CMOs

Glossary

Accrued Interest – Interest deemed to be earned on a security but not yet paid to the investor.

Average Life – Weighted-average time expected for principal repayment, based on prepayment assumptions.

Cash Flow – Principal and interest payments generated by mortgage loans.

Collateral – The underlying mortgage loans supporting a security. It may also include letters of credit, insurance policies or other credit enhancements.

CUSIP – A nine-digit alphanumeric identifier assigned to each series of securities, developed by The Committee on Uniform Security Identification Procedures, used as a uniform method of identifying securities.

Extension Risk – The risk that interest rates may slow the expected prepayment speeds, causing the return of principal to occur later than anticipated.

Face Value – The par value of a security.

Factor – A decimal value reflecting the proportion of the outstanding remaining principal balance of a mortgage security or CMO.

Mortgage-Backed Security (MBS) – A security backed by a pool of mortgage loans.

Prepayment – Early repayment of mortgage principal.

Prepayment Risk – Risk that mortgage borrowers repay sooner or later than expected. As a consequence, investors may have to reinvest their principal at a lower interest rate.

Principal – Original amount borrowed or invested.

Tranche – A class of securities with distinct payment characteristics.

Window – The period of time between the expected first payment of principal and the expected last payment of principal.

Yield – Income return earned on an investment.



Stifel, Nicolaus and Company Incorporated

Member NYSE, FINRA and SIPC

Headquarters:

*501 North Broadway
St. Louis, Missouri 63102*

[Stifel.com](https://www.stifel.com)

© 2026 Stifel, Nicolaus and Company Incorporated. All rights reserved.
For intended recipients only.