Mortgage-Backed Securities
A BlackRock Primer
Mortgage-backed securities (MBS) have become an increasingly important part of some investors’ asset allocation strategy. Today, MBS offer the opportunity to diversify a portfolio with a higher yielding, high-quality fixed income investment alternative.

**What are MBS?**

Generally speaking, MBS are bonds representing an ownership interest in a pool of residential mortgage loans. Residential homeowners make mortgage payments which are ultimately pooled each month. These pooled payments are then “passed through” to MBS holders in the form of principal and interest cash flows.

**How are MBS Created?**

To create a MBS, a lending bank first pools together a group of mortgage loans that it has issued. The bank then presents this pool of mortgages to a government-sponsored agency designated to issue and guarantee MBS. These agencies may include the Government National Mortgage Association (GNMA or “Ginnie Mae”), the Federal National Mortgage Association (FNMA or “Fannie Mae”), or the Federal Home Loan Mortgage Corporation (FHLMC or “Freddie Mac”). Alternatively, private issuers of whole loan MBS may assemble mortgage pools with credit enhancements through a combination of insurance and senior/subordinate structuring.

The agency issuing the MBS guarantees the timely payment of principal and interest to MBS investors. The principal and interest payments the mortgage borrowers pay to the bank are “passed through” to MBS investors each month. **Investors can purchase individual MBS securities, or mutual funds comprised of MBS holdings from firms like BlackRock.**

**Who Issues MBS?**

In order to facilitate the flow of funds to the housing industry, the U.S. Government created three major housing agencies to support the mortgage market.

**Ginnie Mae**—The first MBS was issued in 1970 by the Government National Mortgage Association (GNMA). Ginnie Mae is a government-owned corporation that issues MBS backed by the full faith and credit of the U.S. Government. As a direct obligation, the timely payment of principal and interest is guaranteed, regardless of mortgage payments or default.

**Fannie Mae**—The Federal National Mortgage Association (FNMA) is a stockholder-owned, government-sponsored corporation subject to Treasury regulations, and has a line-of-credit with the U.S. Government. Fannie Mae MBS are considered a moral obligation of the U.S. Government, providing Federal agency credit quality.

**Freddie Mac**—The Federal Home Loan Mortgage Association (FHLMC) is a stockholder-owned, government-sponsored corporation established to increase mortgage credit and provide liquidity. Like Fannie Mae, Freddie Mac has a line-of-credit with the U.S. Government. Freddie Mac MBS are considered a moral obligation of the U.S. Government, offering Federal agency credit quality.

Both Fannie Mae and Freddie Mac MBS generally offer higher current yields than Ginnie Mae MBS in order to compensate for their slightly lower perceived credit quality.
What are the Effects of Interest Rate Changes on MBS?
When interest rates fall, principal prepayments typically accelerate, due to increased refinancing and new home buying. As a result, the size of principal prepayments to MBS investors (which consist of both interest and principal) is paid back sooner than expected. This occurs as principal is paid back sooner than expected.

When interest rates rise, principal prepayments tend to decelerate, as refinancing and home buying typically decrease in a higher interest rate environment. Typically, the size of principal prepayments lessens and the estimated maturity of the MBS lengthens. Given these possibilities, MBS investors must rely on statistical information to anticipate the rate of principal prepayments, as well as the estimated maturity of the security.

What are the Benefits of These Agencies?
Together, these agencies help to effectively lower lending rates on residential mortgage loans. They also facilitate the flow of funds to the U.S. housing industry by providing lending institutions with the money they need to offer additional mortgages.

How are MBS Different from Other Fixed Income Securities?
Unlike other fixed income investments, which typically pay periodic interest and return principal in one lump sum at maturity, MBS make interest and principal payments to investors on a monthly basis. As such, MBS investors receive their principal back over the life of the investment, instead of only at maturity. This occurs as the monthly loan payments made by homeowners are passed through to MBS holders.

Because homeowners can prepay their mortgage loans in advance, the size of MBS monthly payments and the bond’s maturity are only estimated and can vary. In exchange for their estimated payment and maturity characteristics, MBS generally offer a yield advantage over other comparable-quality fixed income securities.

How Do Prepayments Affect MBS?
Principal prepayments can affect both the monthly income stream and the maturity of a MBS. In theory, if every homeowner in a pool of mortgages made their monthly payments on time and held their mortgages for the full term (for example, 30 years), MBS investors could expect to receive equal monthly payments of principal and interest for 30 years.

However, homeowners can choose to prepay all or part of their mortgages prior to maturity. This is known as “principal prepayment.”

Types of Principal Prepayments
One type of prepayment is known as refinancing. Refinancing typically occurs when interest rates decline, providing mortgage borrowers with the opportunity to take advantage of lower mortgage rates. When this refinancing occurs, the prepaid principal is returned to the lending bank, and then passed through to MBS investors.

Prepayments also occur through home sales. When homeowners relocate or simply want to buy another home, the sale results in the prepayment of the principal amount due on the existing mortgage. Again, this principal prepayment is then passed through to MBS investors.

Another type of prepayment occurs when mortgage borrowers add to the minimum principal amount due each month on their mortgage statements. In this way, they accelerate the payment of principal, effectively paying off the loan before it’s due.

When MBS are prepaid during periods of declining interest rates, investors will generally be forced to re-invest the proceeds at a lower rate of return.
What are the Investment Advantages of MBS?

High Credit Quality—MBS issued by Ginnie Mae are direct obligations backed by the full faith and credit of the U.S. Government, guaranteeing timely repayment of principal and interest. MBS issued by Fannie Mae and Freddie Mac provide Federal agency credit quality. Whole loan MBS afford “AAA” credit quality through a combination of insurance and senior/subordinate structuring.

Attractive Current Yields—MBS offer attractive current yields that are typically higher than those of other comparable-quality fixed income securities. This compensates investors for the variable maturity and payment characteristics of their MBS holdings.

Monthly Income—Unlike other fixed income securities, MBS make monthly income payments (of principal and interest), rather than semi-annual payments. This provides investors with reinvestment opportunities as well as regular income for meeting current expenses.

A Variety of Estimated Maturities—MBS are available in a wide range of estimated maturities in order to meet investors’ different financial planning time horizons.

Why Invest in MBS Funds Versus Individual MBS Securities?

Active Management—The primary benefit of investing in MBS funds versus an individual MBS security is active management. By owning actively managed funds, investors can benefit from fund managers’ depth of experience, as well as their access to research resources.

Diversification—Another important benefit of owning MBS funds is diversification. By owning funds that contain a variety of MBS securities, investors can conveniently diversify their risk across such factors as credit quality, sensitivity to interest rates, and prepayment risk.

Low Minimum Investment—MBS funds offer individual investors greater affordability in achieving diversification due to their low minimum investment compared to individual bonds.

What MBS Funds Does BlackRock Offer?

BlackRock’s primary MBS offering is its BlackRock GNMA Fund. The Fund invests primarily in securities issued by Ginnie Mae, as well as other U.S. Government securities in the five- to ten-year maturity range. The Fund normally invests at least 80% of its assets in GNMA securities. Securities purchased by the Fund are rated in the highest rating category (AAA or Aaa) at the time of purchase by at least one major rating agency, or are determined to be of similar quality by the portfolio management team. The Fund measures its performance against the Lehman Brothers GNMA MBS Index.

Investors can also gain exposure to the MBS sector through several other BlackRock funds, including our Core Bond Total Return Portfolio, our Core PLUS Total Return Portfolio, and our Government Income Portfolio. These Funds offer exposure to GNMA and other MBS securities, as well as a broader array of fixed income instruments.

MBS Funds at BlackRock

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<th>Fund</th>
<th>Share Class</th>
<th>Ticker</th>
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You should consider the investment objectives, risks, charges and expenses of the fund(s) carefully before investing. For complete information about any of the BlackRock funds, including objectives, risks, charges and expenses, you may obtain a prospectus from BlackRock Distributors, Inc., 760 Moore Road, King of Prussia, PA 19406. 800-882-0052. Please read the prospectus carefully before you invest or send money.

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