Prepayment Risk 
and Expected MBS Returns*

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Abstract

We present a simple, linear asset pricing model of the cross section of Mortgage-Backed Security (MBS) returns. We measure prepayment risk and estimate security risk loadings using real data on prepayment forecasts vs. realizations. Estimated loadings are monotonic in securities’ coupons relative to the par coupon, as predicted by the model. Prepayment risks appear to be priced by specialized MBS investors. In particular, we find convincing evidence that prepayment risk prices change sign over time with the sign of a representative MBS investor’s exposure to prepayment risk.

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