Tranches

Tranches are pieces, portions or slices of debt or structured financing. Each portion, or tranche, is one of several related securities offered at the same time but with different risks, rewards and maturities. For example, a collateralized mortgage obligation CMO offering a partitioned mortgage-backed securities MBS portfolio might have mortgage tranches with one-year, two-year, five-year and 20-year maturities, all with varying degrees of risk and returns.

- Basically a piece of the whole pie, in which the whole pie is the pool. Each piece has their own measurement of attributes, such as risk level and maturity date.

A tranche is a common financial structure for debt securities such as mortgage-backed securities. These types of securities are made up of multiple mortgage pools that have a wide variety of mortgages, from safe loans with lower interest rates to risky loans with higher rates. Each specific mortgage pool also has its own time to maturity, which factors into the risk and reward benefits. Therefore, tranches are made to divide up the different mortgage profiles into slices that have financial terms suitable for specific investors. If an investor wants to invest in an MBO, he can choose the tranche type most applicable to his risk aversion and desired return.

A single tranche will be made up of a pool of mortgages with similar or the same dates of maturity. Investors who desire to have long-term steady cash flow will invest in tranches with a longer time to maturity. Investors who want short-term income that is comparatively higher will invest in tranches with a shorter time to maturity.

All tranches, regardless of interest and maturity, allow investors to customize investment strategies to their specific needs. Conversely, tranches help banks and other financial institutions attract investors across many different profile types. Investors run the risk, however, of investing in the wrong tranche and missing their investment goals. Tranches add to the complexity of debt investing and it sometimes poses a problem to uninformed investors. Further, tranches are sometimes given a higher rating than deserved, causing investors to invest in riskier assets than they expect.

- Transfer of risk, the bank transfers all or most of its risks to the investor, should there be a rise in the rate of default on mortgages that a tranche settled on, the investors that invested in that tranche are in risk and lost money.

http://www.investopedia.com/terms/t/tranches.asp