GRANT'S

INTEREST RATE OBSERVER®

Vol. 35, No. 19c | Two Wall Street, New York, New York 10005 • www.grantspub.com | OCTOBER 6, 2017

Preferred income

The Fed's tightening cycle proceeds with deliberate speed—fast enough to worry the borrowers, slow enough to vex the savers. Readers ask where they can turn for income.

Fixed-to-floating preferred shares—issued by a trio of mortgage real estate investment trusts—are one possibility. They are nobody's idea of a Treasury bill. Probably, widows and orphans, who require more certainty and less optionality in their investment portfolios than mortgage securities can provide, should steer clear (they can buy more bitcoin). Then, again, when was it given to mortal man to invent his own idealized security? You take the world as it is, or you have to find another one.

Now that the Fed's massive iceberg of a balance sheet is melting, the mortgage REITs are looking over their shoulders. Each month, starting this month, $6 billion of Treasurys and $4 billion of agency mortgage-backed securities will be allowed to run off. There's a lot to run. Since the crisis, the Banks of Bernanke and Yellen have accumulated $1.8 trillion of MBS, representing 18% of America's first mortgages.

So it's a good time to revisit some familiar *Grant's* names—AGNC Investment Corp. (AGNC), Annaly Capital Management, Inc. (NLY) and Capstead Mortgage Corp. (CMO), each on the Big Board. We surveyed the three in the issue of *Grant's* dated July 10, 2015. Back then, NLY and AGNC traded at a 25% discount to book value, while their dividend yields topped 12%. Since then, the common shares have rallied by 66% and 51%, respectively, versus 22% for the S&P 500. A confession is in order. We were least excited about the best performer, Annaly. We were bullish on the laggard, Capstead, which gained a mere 4.1% since publication, when it was quoted at a 6% discount to NAV and yielded 10.6%.

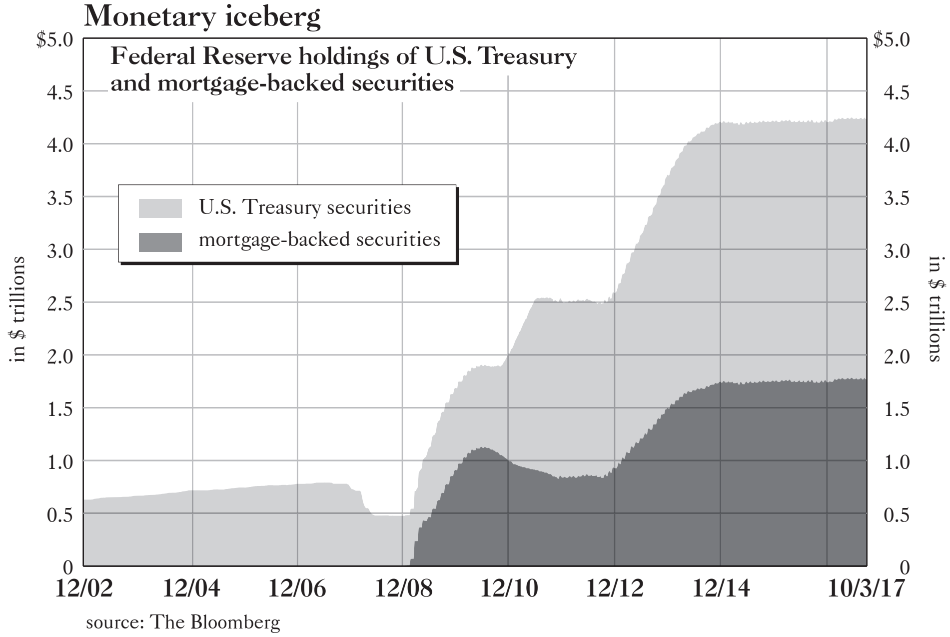
The three companies invest primarily in agency MBS, triple-A-rated pools of residential loans guaranteed by the Federal National Mortgage Association, a.k.a., Fannie Mae; the Federal Home Loan Mortgage Corp., a.k.a., Freddie Mac; or the Government National Mortgage Association, a.k.a. Ginnie Mae.

The MBS offer an only slightly higher yield than Treasurys do, yet the mortgage REITs that hold those securities deliver yields many times greater than the ones that the Treasury pays. The REITs do it the old-fashioned way—they leverage.

The arithmetic works this way: Say that your MBS pay 2.5%, while your financing costs set you back by 1%. You go out and borrow six times your capital to generate 9%, i.e., 1.5% times 6. Add in the 2.5% from the equity capital you started with (no borrowing cost associated with that), subtract 1.5% in operating and hedging expenses and—voila!—you have produced, which is to say manufactured, a 10% return on capital.

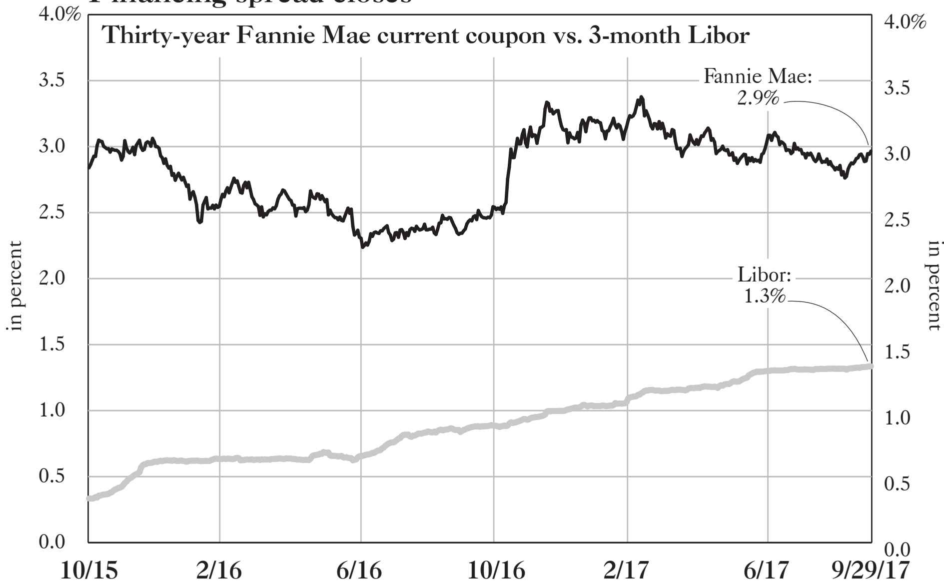
By now, the observant reader will have realized that we are talking about a kind of options bomb. The 10% return is contingent. It depends on the level of rates, the spread between yields and funding costs, the cost (and effectiveness) of hedging strategies and, not least, the speed of mortgage prepayments. These variables were hard enough to manage

Monetary iceberg



source: The Bloomberg

Financing spread closes



source: The Bloomberg

when the Fed was buying MBS. They will be no easier to control now that the Fed is, in effect, selling them.

Somewhere in the Constitution is enshrined the right of every American householder to refinance his or her mortgage whenever the opportunity presents itself. The flip side of this right is the duty of a lender to surrender a relatively high-yielding asset in times of falling interest rates and to hold, though it deeply pains him, a relatively low-yielding asset in times of rising interest rates.

AGNC Investment Corp., which changes hands at 104% of book value to deliver a 9.96% dividend yield (on the common, that is), holds $61.9 billion of fixed-rate agency mortgages, the very kind that the Federal Reserve is poised to own fewer of. The Fed taketh away—and, also, the Fed giveth. On the generosity side of the ledger is the monetary snake oil which the central bank has poured over the once storm-tossed waters of the credit markets. The collapse in volatility has reduced the cost of hedging to near historic lows. Seizing the chance to buy cheap insurance, AGNC had hedged 98% of its funding liabilities on June 30, up from 90% three months before.

It's one thing to hedge the cost of liabilities alone. It's another, and far more difficult, to hedge the "funding spread," i.e., the yield on assets minus the cost of liabilities. The fatter the spread, the more prosperous the REIT, other things being the same. In 2013, when the bond market took a tumble in response to then–Chairman Bernanke's hint that the Fed might conceivably, one day, stop suppressing interest rates, the narrowing of the funding spread nicked AGNC's prosperity to the tune of a 15.8% reduction in book value.

Gary Kain, CEO of AGNC, tells *Grant's* that, in his opinion, markets have discounted the Fed's ever-so-gradual planned withdrawal from the MBS market. Altogether, he says, the stars are in alignment: "Asset pricing, funding and low interest rate volatility—they are all coming together, setting a favorable environment for returns on our positions."

Certainly, Kain knows his business, but the shares are priced for that fact. In view of the absence of a meaningful discount to NAV, we see relative value in AGNC's 7% Series C Fixed-to-Floating Rate Cumulative Redeemable Preferred, which trades at $25.75. The shares pay a quarterly fixed coupon till October 2022, when they're callable at the $25 par price or reset to a premium of 511 basis points over the three-month London interbank offered rate (Libor). The 13 million shares outstanding are priced to deliver a current yield of 6.8% and a yield to call of 6.3%. Dividend coverage is more than ample, with net interest income minus operating expenses amounting to 25 times the preferred payout.

Annaly is the biggest and most eclectic of the three. At $13.3 billion, its equity market cap is 1.6 times AGNC's and 14.3 times CMO's. The shares change hands at a 10% premium to book value and deliver a common-equity dividend yield of 9.8%. Annaly has several distinguishing features, apart from its scale. For one thing, it is externally managed. This means that the bigger the balance sheet, the better for the external managers, who happen to be the same as the operating managers. By dint of size alone, you'd expect that Annaly would be a model of low-cost, efficient management. The figures say otherwise. In the first six months, Annaly's general and administrative expenses represented an annualized rate of 1.9% of common equity compared with AGNC's 0.94% and tiny Capstead's 1%.

Credit risk is another singularity. Credit-senstive assets constitute 20% of Annaly's capital exposure, up from 11% in 2014. Such holdings include non-agency mortgage securities, commercial real estate loans (and securities and equity), along with middle-market business loans.

Such non-mortgage exposure has succeeded in smoothing the volatility that's inherent in mortgage investing. Since 2013, Annaly's dividend has remained stable, while the dividends of mortgage REITs that hold nothing but agency MBS have fallen by 7%, according to the company's own research. To mitigate the risk of credit exposure, Annaly deploys a lower overall ratio of debt to equity than its peers—6.4:1 versus AGNC's 8.1:1. The Annaly credit portfolio itself is leveraged 2.1:1.

Only slightly more than two-to-one sounds harmless enough, but the credit cycle isn't getting any younger. Consider, for instance, the 23% retail exposure in the commercial real estate portfolio or the 23% exposure to subprime credit in the residential credit group. Two times the trouble, when trouble comes, may prove burdensome.

Safer than the common stock, we think, is the Annaly preferred, specifically the 6.95% Series F Fixed-to-Floating Rate Cumulative Redeemable Preferred; $700 million came to market in July to refinance a more expensive Annaly issue. The new shares trade at $25.55, which includes 31 cents in accrued dividend. The stock pays a 6.95% quarterly dividend until September 2022 when it becomes callable at par ($25) or the dividend resets to three-month LIBOR plus 499 basis points. If rates go up, the coupon resets higher; if down, the issue may get called away, delivering a 6.7% yield to call to today's buyer. In the first six months of 2017, net interest minus expenses covered preferred dividends by a factor of 12.7:1.

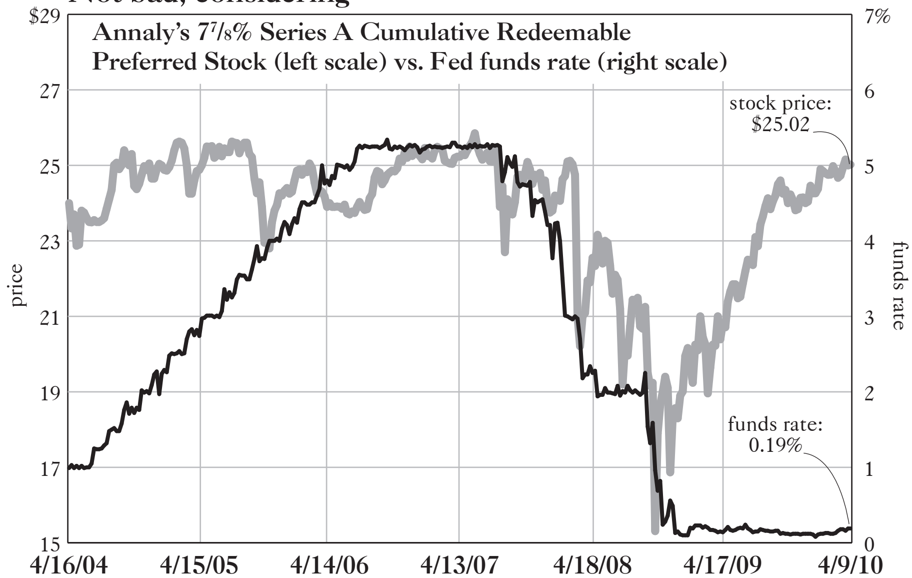
Interest rate risk is perhaps not so worrisome as it might appear, even in the fixed-rate phase of the life of a fixed-to-floating security. Such, at least, is the conclusion we draw from the trading pattern of Annaly's purely fixed-rate 7⅞% Series A Cumulative Redeemable Preferred, which debuted in March 2004.

At the time, the funds rate was 1%. Two years and 17 rate hikes later, the funds rate was pushing above 5%. Still, the Annaly issue held in a range between $23.50 and $25, and mostly above $24. The preferred shares fell out of bed in 2008, along with everything else, skidding to $18, but was back above $24 by the end of 2009. Maybe the new, diversified Annaly will cut a different figure in the market—who knows how its credit exposure will hold up the next time business activity wobbles. Anyway, there's an encouraging precedent in the matter of interest rate risk.

Mortgage prepayments have borne down especially hard on Capstead. While AGNC and NLY invest in fixed-rate mortgages, CMO owns mainly the adjustable-rate kind. ARMs bear a lower initial interest cost than a fixed-rate loan, but there is a future day of reckoning on which that teaser rate lurches higher. You'd expect that ARMs would be just the investment for a Fed tightening cycle, but nothing about mortgage investing is that simple.

Not only does an ARM reset, but so, too, does the cost of financing the ARM. Nor do those moving parts necessarily move together. Unhappily for the investor, financing costs are typically more responsive to rising money-market interest rates than ARM yields are. The result is a narrowing in the difference between yield earned and cost paid.

Not bad, considering



source: The Bloomberg

Capstead is a poster child for the risk of a contracting financing spread. In the second quarter of 2014, there were 110 basis points of daylight between what the company earned on its ARMs and what it paid to finance them. Three years later, the spread has been sawed in half. Today, CMO is quoted at 91% of book value—about where it was in the middle of 2015. It pays a 7.8% dividend yield and commands a $933 million market cap. After the abrupt departure of CEO Andrew Jacobs in July 2016, the new CEO, Phillip Reinsch, a Capstead employee since 1993, has been doing double duty as CFO.

If Capstead were quoted at a deep discount to NAV, one might look beyond the tendency of ARMs to underperform relative to fixed-rate mortgages in the early portion of a Fed tightening cycle. But the discount is only 9%, as noted, and the dividend yield 7.8%.

Here, too, there's a preferred alternative: Capstead's 7½% Series E Cumulative Redeemable Preferred (8.2 million shares outstanding), callable in May 2018 at par ($25 a share) and trading at $24.87, a price that includes 3 cents per share in accrued dividends. Yield to the potential call next May is 8.5%.

In the first six months, Capstead showed $111 million in net interest income. After subtracting $5.2 million in expenses, the preferred dividend coverage ratio stands at 13.5 times, which is the average over the past three years.

In a better world, there'd be more to choose from, but this is our world, and some of us need income.

•