GRANT'S
INTEREST RATE OBSERVER®

Vol. 31, No. 16c | Two Wall Street, New York, New York 10005 • www.grantspub.com | AUGUST 9, 2013

Quartered and drawn

In the second quarter, the typical mortgage real estate investment trust suffered a loss of book value per share on the order of 15% and a drop in share price of between 20% and 25%. Rising and roiled interest rates wiped out two years' worth of double-digit dividend yields.

Mortgage REITs are the subject under discussion, and a timely topic it is. MBS—mortgage-backed securities—are hard enough to manage in ordinary times. They are extra rambunctious in interesting ones. Our time will prove to be more than usually interesting if, as we suspect, the great bond bull market that got under way 32 years ago this coming autumn is making way for Mr. Bear.

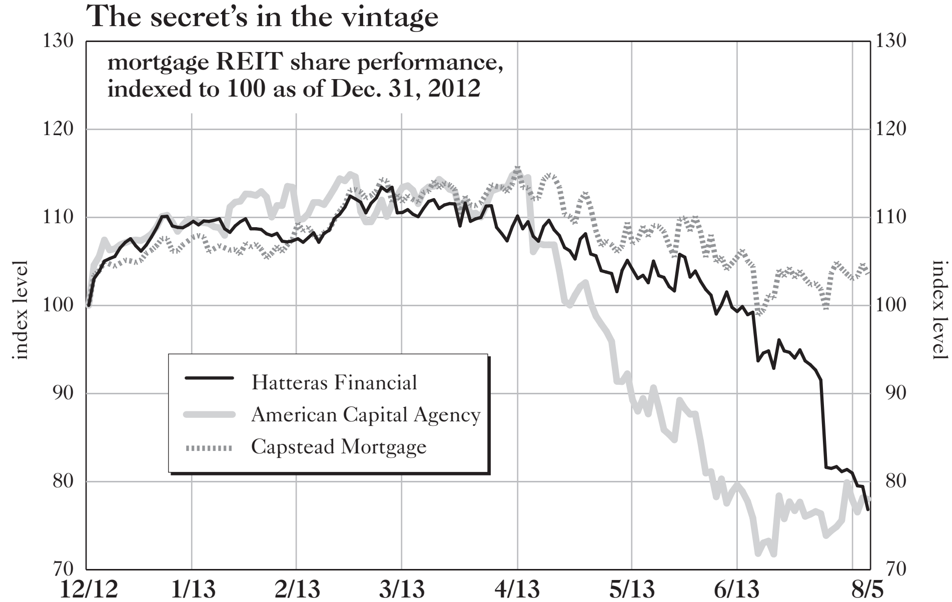
The first order of business is errant analysis—our own. The REIT whose praises we sang a few months back suffered a whopping 21% decline in book value last quarter—it was supposed to be the safe one—while a REIT we judged to be more exposed to rising rates enjoyed, if that's the word, a mere 12% drop in book value. Following is a new, and we trust, improved analysis. (For the unhelpful other, see the issue of *Grant's* dated May 17).

What went wrong at Hatteras Financial Corp. (HTS on the New York Stock Exchange) is easy enough to parse in hindsight. You may recall that, at the close of the first quarter, 89.6% of Hatteras's portfolio was invested in adjustable-rate mortgages (ARMs). But what seemed perfectly adequate armor against an upside lurch in interest rates proved porous; the problem was that only 23% of the Hatteras ARMs reset within three years or less, while fully 32% of the portfolio adjusted in six years or longer.

Capstead Mortgage Corp. (CMO on the Big Board) turned out to be the one with the bulletproof vest. At a glance, you'd almost suppose that Capstead and Hatteras were identical twins. As of June 30, ARMs made up 98% of Capstead's portfolio, 89% of Hatteras's. Swaps and other hedges covered 49% of Capstead's book, 48% of Hatteras's. But, as the second quarter's interest-rate pyrotechnics underscored, not all ARMs are alike. Capstead owns a portfolio of vintage securities that, on average, adjust in less than two years (21.6 months to be exact). The shorter time to reset translated into shorter duration; in the second quarter, shorter duration was the winning hand.

So Hatteras and Capstead weren't twins after all but first cousins once removed. In comparison to the devastation wrought on Hatteras's net worth, Capstead's book value per share fell by 5.9%, which includes the cost of a management-initiated redemption of preferred stock. Without that bit of elective surgery, Capstead could have reported a loss in book value of no more than 3.8%. In consequence, Capstead's debt-to-equity ratio crept higher by one-third of a unit, to 8.4:1 from 8.1:1 between the first and second quarters. Hatteras's leverage ratio leapt by 1.9 units, to 9.3:1 from 7.4:1.

The secret's in the vintage



source: The Bloomberg

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To err is human; it's clinging to error that can cost you money. Of course, it's "stubbornness" when a decision to stay the course yields a loss. Otherwise, it's "conviction" ("ice in his veins," the boys and girls on the trading desks admiringly whistle). In the second quarter, the Hatteras front office was stubborn.

There are more ways to get into trouble with MBS than you can shake a stick at. Trouble is embedded in the very nature of the asset, notably in the option conferred on every living American mortgagor to refinance his or her debt at will. When interest rates fall and homeowners prepay, REITs are stuck with cash; it's the asset that nobody wants in a bull market. But when interest rates rise and borrowers stand pat, REITs are stuck with bonds; they are the assets that nobody wants in a bear market. Investors in Treasurys know the duration of their securities. Investors in MBS can only guess about theirs.

Duration, the most basic measure of the sensitivity of the price of a bond to movements in interest rates, was the defining difference in second-quarter outcomes. The more successful managers seem to have anticipated that, as the practitioners put it, mortgages would "trade longer than the model." In other words, as rates rose to the accompaniment of the Fed's tapering talk, MBS sold off more than a left-brained analyst would have expected them to. Their prices became more sensitive to rising rates than most had bargained for. So MBS prices fell to reflect both the actual rise in rates and the fear of rises yet to come. Which is to say that the duration of the MBS became elongated. Bonds that, by common consent before the storm, had 2.5-year durations presently became, in the market's eyes, bonds with five-year durations. It seems that Hatteras's new vintage "7-1" ARMs were caught up in this mortgage meat grinder.

Though the MBS duration models are mathematically rigorous, they are only as good as the assumptions they're built on. And if the writers of the software have absorbed the lesson that interest rates always go down, rarely go up and never stay up (the history of the past 30-odd years in a nutshell), their mortgage models will reflect that bull-market expectation.

Delivering income
(in $ millions)

	market cap.	div. yield	price/ book	start date	end date	total ret. (div. inv.)	annual eq.
Annaly Capital	$10,988	13.8%	76%*	10/10/97	8/2/13	482%	12%
American Capital	8,918	18.7	88	5/16/08	8/2/13	200	23
Hatteras Financial	1,890	14.6	86	4/25/08	8/2/13	69	10
Capstead Mortgage	1,130	10.5	92	9/6/85	8/2/13	2,264	12

* first-quarter book value
sources: The Bloomberg, company reports

"As we look across portfolios and listen to managements, a number of them suggest asset durations that don't look right to us," Michael Widner, equity research director at Keefe, Bruyette & Woods, tells *Grant's*. "They just look too low. It looks like they are applying an assumption that rates are as equally likely to rise as they are to fall. That might have been historically true, but I think the market is clearly telling us it doesn't agree with that assumption anymore. The market believes rates are much more likely to rise. Bond duration estimates are built with sophisticated tools, like binomial pricing models or Monte Carlo analysis, or whatever. But those are just tools, and if you don't adjust the 'equally likely to rise or fall' assumption, you are going to get answers different than the market. Then the market is going to keep crushing your bonds more than you think, and you will be more exposed to duration risk, and you will keep losing book value as rates rise."

For now, Hatteras is sitting with more leverage than either its management or the market seems comfortable with. On the earnings call, CEO Michael R. Hough said that he will reduce leverage "through possible appreciation, portfolio runoff and/or portfolio sales." But prices might not appreciate. If a new bond bear market were, in fact, in progress, prices would inconveniently depreciate. And if rising prices didn't reduce leverage the painless way, falling prices could force a reduction in leverage the hard way, via asset sales. If so, a dividend cut would likely be in the cards.

As it is, Hatteras changes hands at 86% of book value and yields 14.6%. American Capital Agency Corp. (AGNC on the Nasdaq)—still getting Mr. Market's stink eye—trades at 88% of book and yields 18.7%. Capstead, the mortgage REIT of the year thus far in 2013, trades at 92% of book and yields 10.5%—since January, its share price has actually risen by 3%, compared to declines of 23% for AGNC and 22% for Hatteras.

The question before the house is whether AGNC's 48-year-old president and chief investment officer, Gary Kain, can keep doing what he just did so well. At the end of the first quarter, it seemed as if AGNC were the top candidate for the unwanted title of "Mortgage REIT Least Likely to Succeed in an Interest Rate Updraft." Late in 2012 and in the opening months of 2013, the company paid a premium for securities with prepayment protection; the clear and present danger was falling rates, Kain had evidently decided. But rates registered a small rise instead, and the premium prices that prepayment-protected MBS had commanded melted away. As a result, AGNC suffered an 8.5% drop in book value during the first quarter, while Hatteras's book was essentially unchanged. On March 31, AGNC's balance sheet was leveraged 8.1:1, and fixed-rated securities made up 86% of the portfolio. Hedges protected—though who knew how well?—73% of the holdings.

But, lo and behold, Kain ducked and covered, as Hatteras did not. Between April 1 and June 30, AGNC shrank its portfolio by $11.9 billion, to $91.7 billion. It pared back 30-year, fixed-rate mortgages as a share of overall holdings to 56% from 64% and reciprocally boosted its holdings of shorter-duration, 15-year, fixed-rate mortgages to 42% from 34%. For good measure, it boosted the hedge book to cover 97% of the portfolio and more than 100% of funding liabilities.

"We have never been as hedged as we are today," Kain tells colleague Evan Lorenz. "We've repositioned

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the portfolio into a different mix of assets—we've migrated from our biggest priority being prepayments and carry and yield to having a portfolio that will shorten more quickly as it seasons, even if interest rates go up. . . . You've followed the REITs for a while. I don't think you've ever heard of a REIT that has over 100% of their repo balance covered and the average duration of our hedges is over five years. It's not like we have it covered with two-year swaps. We have a lot for 10 years."

Still and all, Kain went on, AGNC is not betting on higher rates. It is, rather, protecting itself against the risk of higher rates, a different matter: "We are just going to be in a defensive position. To be perfectly honest, some of the logic there comes from a recognition of what the equity market is telling us. The equity market is trading the REIT stocks at 85% to 90% of book. What we take away from that is that the equity market is basically saying, 'I'm not worried about how much money you guys are going to make. I'm worried that you are going to do something stupid.' Our mind-set is that investors will end up making money when they can buy reasonably priced assets—mortgage securities at this point—at 85% to 90% of the market value of those assets. That's a pretty darn good trade. They don't need us to take a lot of incremental risk around that right now."

AGNC, with $98.7 billion of assets on June 30, is the second-largest REIT by balance-sheet size behind Annaly, with $125.5 billion under management as of March 31. (Annaly is set to report on its second quarter on Aug. 14.) Since going public on May 14, 2008, American Capital Agency Corp. has delivered a compound annual return of 23.1% with dividends reinvested, far ahead of the runner-up, MFA Financial Inc. (MFA on the Big Board), which managed an 18% compound annual return, also with dividends reinvested. (Had you been squandering your dividends on food and shelter instead of reinvesting them, AGNC and MFA would have provided you with compound returns of 18.6% and 12.6%, respectively.)

"In the stock market," we wrote in the issue of *Grant's* dated Feb. 22, "active management has yielded—how to put this diplomatically?—mixed results." Can active management—in the case of AGNC, very active management—reliably deliver the goods in the mortgage market?

"The way I think about Gary Kain is he almost has a hedge-fund, kind-of-fast-money bent to him vs. the other guys, who are more buy and hold," Widner, the KBW analyst, reflected. "It is the nature of that hedge-fund-style manager that you are going to have higher volatility but you also hope it comes with outperformance overall. So far, Gary has delivered, and it is hard to take that away."

"So far" is, of course, the rub. The nimblest and most knowledgeable of managements sometimes zig when they should have zagged. When interest rates rise, the cost of a dollar's worth of income falls. In a bond bear market, mortgage REITs would be struggling periodically against gale-force headwinds. Recall that AGNC, as ably and dexterously managed as it was in April-June, shed 12% of its book value over those three months.

As the table points up, REIT stocks are quoted at a sizable discount from book value, and their dividend yields are historically elevated. Our concerns are everyone's; to a degree, prices duly reflect them. But, in a proper bear market, concerns that were seemingly priced in are often quickly displaced by new concerns that were not, in fact, priced in.

In response to a *Wall Street Journal* op-ed article by Mortimer Zuckerman extolling the work of Ben S. Bernanke, Sam Foster, a *Journal* reader from El Segundo, Calif., wrote a letter to the editor. "If Ben Bernanke was, as Mr. Zuckerman says, 'instrumental in saving the country from financial catastrophe,' he did it by robbing Peter to pay Paul," Foster led off.

> I'm 68 years old, have worked 60-70 hours a week for 45 years to come from nothing to consistently earn in the top 2% in the nation. I've lived frugally so I could fulfill my responsibilities to my wife and children and retire with grace. Like most prudent investors who count on their savings to support them in retirement, my investment choices have become progressively less risky. I had presumed to be able to obtain a 4% or 5% yield and live comfortably on very low-risk investments. But thanks to Mr. Bernanke, that number will be more like 1% to 1.5%. Does Mr. Zuckerman have any idea how much money a man must have to live on 1% yields?
>
> So I am Peter. Mr. Bernanke has stolen 20 years of leisure retirement from me. Thanks to him I will now work until I die.

What would we at *Grant's* say to the *Journal*'s aggrieved correspondent? Must he settle for 1%—or even 4% or 5%—when AGNC is priced to deliver more than three times 5%? To Mr. Foster, we would say that the mortgage REITs have produced wonderful, leveraged returns for a very long time, a time that happens to coincide with a persistent fall in interest rates.

Capstead, the oldest of the lot—it went public in the third quarter of 1985—has served up a compound annual rate of return from then till now of 12%, with dividends reinvested. And Capstead is, as noted, positioned now for heavy weather. One's stance toward the mortgage REITs will, therefore, depend on one's view of the weather, or—with respect to a possible shift in secular movement of mortgage rates—the climate.

We have our view. Mr. Foster will have to formulate his.

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