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Like typos

It's Ben Bernanke's world and interest rates are his to command. Starting at zero percent and stopping, in the case of investment-grade corporate bond yields, at not much more than 4%, they are little tiny rates. But there are rates at the other extreme, too. Yields on mortgage real estate investment trusts range as high as 17%. They look like typos.

Such returns, and the risks associated with plucking them, are the subjects under discussion. In preview, we judge that the returns are worth the risks—just. The speculator who manages to cop a mid-teen yield in 2012 has well and truly earned it.

And make no mistake: You, the investor in Annaly Capital Management (NLY), American Capital Agency Corp. (AGNC), Hatteras Financial (HTS) or MFA Financial (MFA) are a speculator. Determinants of the success of your speculation include: No. 1, the shape of the yield curve; No. 2, the nimbleness of your management in juggling financial leverage with asset selection and liability management; and No. 3, the various federal policies that confound even well-laid plans. Good luck to you!

Of fundamental importance to your adventure in mortgage REITs is the sheer perversity of the mortgage-backed security. In 21st-century America, the borrower (with the government and the law at his elbow) holds most of the cards. Let interest rates fall, and he refinances. Let interest rates rise, and he stands pat. Assets, therefore, tend to be called away from a creditor when they are appreciating—and not to be called away when they are depreciating. When you, the creditor, want them, they go away, and when you want them to go, they stay. It sounds like a love song. You do your best to hedge, but you can never hedge away every risk.

To judge by the Treasury yield curve alone, these are the good old days. The difference between the two-year and 10-year points on the continuum of government borrowing rates measures 1.93%, whereas, since 1990, it has averaged 1.16%. Because mortgage REITs borrow short and lend long, the steeper the curve, the better they like it. And it has been steeper—as radically tilted as 2.91% in February 2010. It has become steadily flatter, especially since, starting on Sept. 21, the Bank of Bernanke turned a seller of short-dated assets and a buyer of long bonds, a manipulation known as Operation Twist.

With only a few small steps in the direction of interest-rate normalcy, the curve could become a great deal flatter. The two-year note is quoted today at all of 37 basis points, much less than the year-over-year rise in the CPI. If the two-year note were to yield 50 basis points, the curve would flatten to 1.8%, other things being the same. If the two-year were to yield 1%, the curve would flatten to 1.3%, other things being the same. One thing, at least, would not be the same: The REITs would be knocked for a loop.

The federal government has many a surprise it might spring. For instance, one of these days the SEC might pass judgment on whether the mortgage REITs will continue to enjoy their exemption from the 1940 Investment Company Act, which allows them to run with multiple turns of leverage yet still pay no corporate taxes (an exemption that certain other businesses, including commercial mortgage REITs and some consumer finance companies, share). The commission has been weighing the matter since around Labor Day.

Then, too, the government has taken it upon itself, via a second iteration of the Home Affordable Refinance Program, a.k.a. HARP,

Mortgage REIT vital signs

name	debt/equity	price/book	div. yld.
Annaly Capital Management (NLY)	5.4x	98%	13.9%
American Capital Agency (AGNC)	7.9	108	16.6
Hatteras Financial (HTS)	7.8	105	12.7
MFA Financial (MFA)	3.7	102	13.2

sources: The Bloomberg, company reports

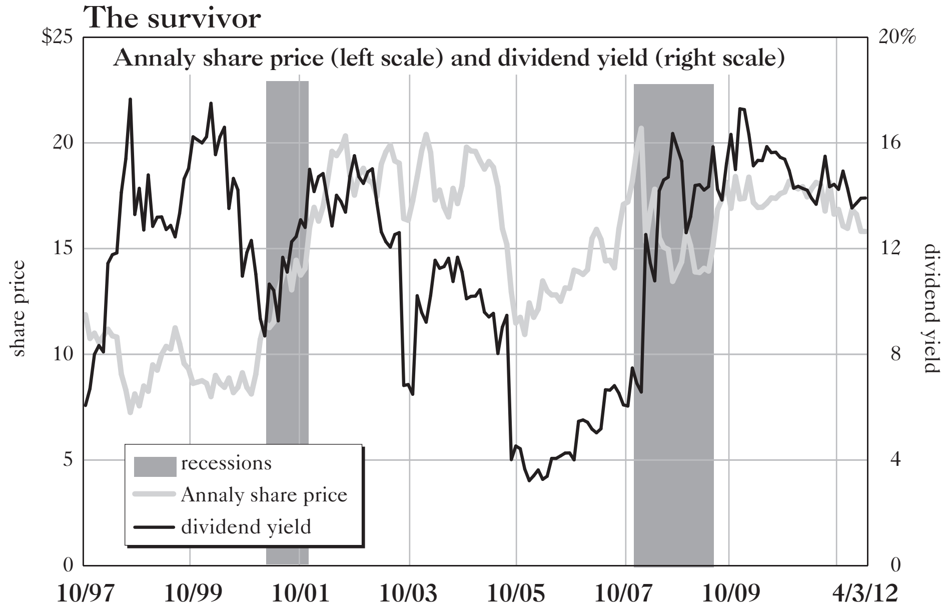
to loosen the eligibility criteria for refinancing federally insured mortgages. For the mortgage REIT that pays, say, 102 cents on the dollar for a Fannie Mae- or Freddie Mac-conforming mortgage, there is no joy in receiving 100 cents on the dollar in a federally sponsored refi transaction. An election-year demarche to promote still more extensive mortgage refinancing is a possibility that no student of this administration can entirely rule out.

And yet, even with all those hovering swords, as Michael R. Hough, CEO of Hatteras Financial Corp., tells colleague Evan Lorenz, mortgage REITs are not without investment appeal. And their No. 1 drawing card isn't the one you think. "This is an investment with proven value for investors," Hough says. "While it has produced high dividend yields in various economic environments, it has probably added the most value to investors by being countercyclical to the U.S. economy and equity market."

Annaly, the No. 1 mortgage REIT by size and longevity in the public equity market, illustrates the point. The year 2005 was a good year for the GDP (up 3.1%), if a mediocre one for the S&P 500 (up 3%). It was, however, a not-good year for the funding costs (the Fed was raising them) or for the yield curve (its slope contracted to minus-0.01% at year-end from 1.15% at Dec. 31, 2004). By the fourth quarter of 2005, Annaly was earning a spread on its assets of just 0.09%. The share price plunged by 44%.

Compare and contrast the *annus horribilis*, 2008. To look at Annaly's results, you'd have hardly guessed that the world almost ended. As against a 38.5% drop in the S&P 500, the Annaly share price fell by 12.7%, or a loss of 1.3% after clipping the coupon, while book value per Annaly share increased by 3.2%.

The mortgage REITs are attractive for another reason. "They are priced as if they implemented the identical business model," Lorenz relates. "They implement a similar business model. The basic approach is the same—borrow short, lend long. But there are different approaches concerning interest rates, prepayment risk, credit risk



source: The Bloomberg

and disclosure. Yet the stocks are all valued at a few percentage points' premium or discount to book value per share. Dividend yields do vary—from a low of 12.7% for Hatteras to a high of 16.6% for American Capital Agency—but company-by-company risk factors vary just as widely, if not more so."

So far, 2012 isn't Annaly's year. On Jan. 26 came the press release disclosing that Michael A.J. Farrell, founder, CEO and public face of the mortgage and credit enterprise, has cancer. Let us just say, with respect to Farrell, this publication is ardently bullish. Then came the admission on March 1 that the Annaly offspring, Chimera, had erred on a question of revenue recognition, would not be able to file a timely 10-K report and, in a subsequent disclosure, that it had fired its auditor, Deloitte & Touche. In following days, Annaly and CreXus, too, parted company with Deloitte.

Annaly, in a manner of speaking, is the father of seven. The subsidiaries include Fidac and Merganser, SEC-registered investment advisers; Chimera and CreXus, REITs that invest in miscellaneous residential and commercial real estate credit; RCap, a broker-dealer with a specialty in repo finance; Charlesfort, a lender that originates senior secured, second-lien and mezzanine debt; and Shannon, a mortgage-warehousing lender. The children aren't very big—in the fourth quarter, they contributed just $28.7 million to the parent's pretax income, compared to the $717.6 million net interest income Annaly's mortgage-based securities portfolio produced. However, like most children, they can be noisy and distracting. Last year at about this time, CreXus was the object of a buyout bid by Starwood Property Trust that would have netted CreXus shareholders $14 a share; CreXus then changed hands at $12.15 a share. No, no, CreXus protested—rather than sell out, it would more than double its own share count in order to buy a discounted commercial real estate loan portfolio from Barclays. There was a kerfuffle, and Starwood went away. Today, the bid—an all-stock transaction, as it was proposed—would be worth $12.68 a share, while CreXus is trading at $10.13.

Over the years, Annaly has delivered results that themselves look like typographical errors: Between the October 1997 IPO and March 2012, its total return, with dividends reinvested, was 623%, compared to 99% for the S&P 500, also with dividends reinvested. Do the learned works on theoretical finance allow for such an extraordinary success? Annaly has achieved its results through leverage and judgment, borrowing just enough to excel but never so much as to drive itself into the ditch.

The biggest of the mortgage REITs—with $109.6 billion of assets, it is almost twice as big as the runner-up, American Capital Agency—Annaly is mainly invested in fixed-rate agency mortgage-backed securities. What's left consists of adjustable-rate MBS (9% of the portfolio) and floating-rate MBS (1% of the portfolio). To defend against an adverse shift in interest rates, management uses swaps to lock in the cost of financing and, thus, the amount of profit-making daylight between its assets and liabilities. At year-end, the notional value of the swaps was equal to 41% of the portfolio, meaning that 49% of those assets behave as if they were fixed rate, 51% as if they were to some degree less rate-sensitive. As of Dec. 31, debt was 5.4 times greater than equity, making Annaly one of the least leveraged mortgage REITs in the field.

Is it therefore the least risky? Maybe not, for of all the mortgage REITs, Annaly discloses the least. To what degree is its portfolio at risk on account of HARP? What is the tenor of the Annaly swaps book? Inquiring minds want to know, but Annaly doesn't say.

American Capital Agency, which went public only in 2008, and which is led by a cadre of former senior executives of Freddie Mac, looks like Annaly at a glance. Like Annaly, American Capital is mainly invested in agency fixed-rate MBS (94% of the portfolio), with the remainder committed to agency adjustable-rate MBS (5%) and agency-collateralized mortgage obligations that include fixed-rate, adjustable-rate and interest-only strips (1%). At year-end 2011, American Capital was leveraged 7.9:1. Like Annaly, it uses swaps to muffle the interest-rate sensitivity of its MBS; they protect 55% of the portfolio. Unlike Annaly, American Capital also uses swaptions, contracts that give their owner the right, though not the obligation, to enter into a swap; they amount to 6% of the portfolio.

"However," Lorenz observes, "the prima facie similarities belie a much greater difference in asset selection, which, in turn, has resulted in divergent patterns in mortgage prepayments. American Capital, to limit prepayments and reduce risk to HARP-induced prepays, has weighted its fixed-rate portfolio to small-balance loans, which are less likely to refinance, and loans from previous HARP refinancings, which are not eligible for a second HARP refinancing, as well as loans originated after 2009. As a result, American Capital's constant prepayment rate (CPR), a measure that annualizes the rate of prepays, was 9% in the fourth quarter compared to 22% for Annaly.

"Another difference between American Capital and Annaly lies in what the companies tell you, or, for that matter, what they don't," Lorenz continues. "Annaly does not disclose enough information about its portfolio to allow investors to handicap the company's risk from HARP-induced refinancing. American Capital does. In addition, American Capital breaks out the tenor of its swaps (3.5 years) and of its swaptions book (7.7 years). Annaly stays mum."

The new "it girl" of the mortgage REIT business, American Capital has, over the past three years, outearned, outgrown and out-disclosed its larger rival. Since coming public in May 2008, American Capital has accumulated $58 billion in assets. It took Annaly 10¼ years to reach the same mark. Then, again, in the 3¾ years ended Dec. 31, 2011, Annaly bolted on another $50 billion. One can fault Annaly for many things, and the company has its detractors. However, its singular and—to our mind—most important asset is the scar tissue it has accumulated over the course of so many interest-rate and prepayment cycles. It has prospered and survived.

A REIT of a different color is Hatteras, whose portfolio is 94.4% invested in agency adjustable-rate MBS, not the fixed-rate kind; the swaps book has a notional value equal to 44% of the mortgage portfolio. "We have, since day one," says Hough, "focused on the ARMs [adjustable-rate mortgages] market as the way to be defensive against rising rates under the assumption that neither we nor our investors ultimately know when the yield curve is going to shift higher or shift upward as a whole, and that these shifts generally happen pretty quickly."

Of course, no strategy is without its drawbacks. Adjustable-rate securities do adjust to changes in interest rates, but by no means instantaneously. Then, too, adjustable-rate borrowers, in comparison to fixed-rate borrowers, show an irksome predilection to refinance, for which reason Hatteras bears a relatively elevated CPR (20.8% in the fourth quarter). "That is fine by us," says Hough. "We are plenty happy to exchange repayment risk for the better protection we get in a rising interest rate environment." Hough adds that he does not stay awake at night fretting about HARP; 90% of the portfolio doesn't qualify for the new program.

Irksome to mortgage REIT investors is the predilection of mortgage REIT managements to issue new shares, thereby to boost book value, and thus—in the cases of Annaly and American Capital, among others—to boost management compensation. As a rule, the bigger the business, the happier the executives (Annaly and American Capital charge 1.5% of equity per annum, regardless of size or investment performance). Hatteras takes a different approach by shrinking management fees as a percentage of equity as equity grows. "So we are," says Hough, "from an expense structure, almost half of what the average is of our peers."

Just last week, Hatteras issued 20.1 million shares for a total of $540 million, in order, says Hough, to fortify its swaps book. "It is a scalable business," he explains. "Effectively, we're adding zeroes to our balance sheet. It does take additional expertise and manpower, but it doesn't double the size of those needs."

MFA is as different from Hatteras as it is from Annaly and American Capital. Whereas the three last-named REITs buy federally guaranteed MBS, MFA makes a specialty of the private-label kind. There's no mistaking which is which. In the fourth quarter, the non-agency portion of the MFA portfolio, worth $4 billion, yielded 7.06%. The agency side, worth $7.1 billion, fetched only 3.14%. Thanks to the taxpayers' guarantee of Freddie and Fannie, agency MBS are eminently leverageable, and MFA borrows $6.60 for every $1 of equity held against agency mortgages. However, because non-agency mortgages can and do default, they are not so easily hypothecated, and the private-enterprise segment of the MFA portfolio was leveraged only a little more than 2:1. While only 36% of the MFA portfolio is invested in non-agency mortgages, those non-guaranteed assets generate 55% of interest income.

Though MFA holds mainly adjustable-rate mortgages, it confronts a different kind of interest-rate risk than do its federal-agency-favoring peers. A bear bond market induced by accelerating GDP growth would likely cause non-agency debt to rally. After all, economic growth reduces credit risk. MFA's kind of mortgage-backed securities—ones that were knocked around in the housing bust and therefore trade at a discount to par—would certainly perform better in a prosperous economy than in a sinking one. Only consider the alternative case: Between Sept. 30 and Dec. 31, amidst the vapors of a weak stock market and the European debt predicament, MFA's book value per share fell by 5.9%, to $6.74 from $7.16. By Jan. 31—following the European Central Bank's printing spree—book value had recovered to $7.10. In a move to secure safer and less volatile sources of funding, MFA in the fourth quarter entered into arrangements for $300 million of three-year collateralized financing for non-agency MBS, subsequently expanded to $500 million after the quarter's close. Repurchase financing, which is shorter term in duration, had declined to 37% of total non-agency financing on Dec. 31, 2011, from 53% on Dec. 31, 2010.

Having studied anew the field of mortgage REITs, we have decided to take a diversified approach. Each of the four has its strengths and weaknesses. We find ourselves favoring Annaly for experience, American Capital for dash, Hatteras for economy and MFA for innovation. For those who need income and would speculate to get it, consider a blended portfolio: some of each flavor.

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