INTEREST RATE OBSERVER[®]

Vol. 31, No. 4b

Two Wall Street, New York, New York 10005 • www.grantspub.com

FEBRUARY 22, 2013

Oases of income

Try as it might, the Fed can't seem to stomp out every last source of interest income in America. Mortgage RE-ITs and business development companies, for instance, still yield enough to sustain the body and spirit of your favorite charity, retiree or lay-about heir. Following is an update on the risks and rewards of yield hunting.

Mortgage real estate investment trusts, as every paid-up subscriber knows, are leveraged yield machines. Mortgage-backed securities stock the asset side of their balance sheets. Repurchase agreements are the mainstay item on the liabilities side. As the yield curve fluctuates, so fluctuates a REIT's income-generation power. The wider the gap between mortgage yields and the cost of financing—i.e., the steeper the curve—the better it is for the stockholders.

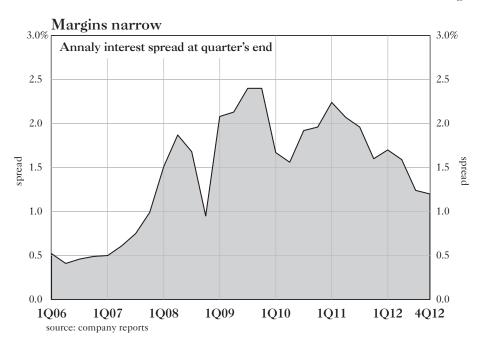
When, on Sept. 13, the Federal Reserve disclosed plans to buy \$40 billion of mortgage-backed securities every month until it sees the whites of the eyes of prosperity, prospects seemed to dim for mortgage REIT investors. Week by week, the Fed would be buying more mortgages than the market originated-surely, the rising prices of residential mortgage-backed securities would squeeze margins and, perhaps, nudge homeowners to trade in their current mortgages for cheaper, lower-coupon models. And so it has come to pass, though Mr. Market, no respecter of authority, had the temerity to frontrun the purchases of the Bank of Bernanke. So it is that since the official start of QE3, the prices of some MBS have actually fallen.

Altogether, it's been no bed of roses for the mortgage REITs. In its report for the fourth quarter, Annaly Capital Management, the biggest of the lot, disclosed a year-to-year decline of 21.1% in its dividend and a 1.3% fall in its book value per share. At year-end 2012, the spread that Annaly earned between the yield on its RMBS and the cost of its funds fell to 1.2% from 1.6% at year-end 2011 and from as much as 2.4% at the close of 2009.

Nor, to judge by its deeds, does the Annaly front office expect a quick return to fat and stable spreads. In the final three months of the year, the CEO, Wellington J. Denahan-Norris, chose to repurchase shares (27.8 million of them for \$397.1

million, to be exact), diversify into commercial mortgages and extinguish debt rather than invest in RMBS. Diversification took the form of a Nov. 12 bid to complete the purchase of the outstanding shares of a commercial mortgage REIT called CreXus (CXS on the Big Board). Annaly's investment mandate permits the allocation of up to 25% of its capital into securities not blessed by agencies of the federal government. Should the CreXus acquisition be completed, Annaly would have the equivalent of 6% of capital tied up in mortgages secured not by the Treasury, but by office buildings, shopping malls, warehouses and the like.

"On a trade-level basis," says Denahan-Norris in response to a question about how returns in CMBS might

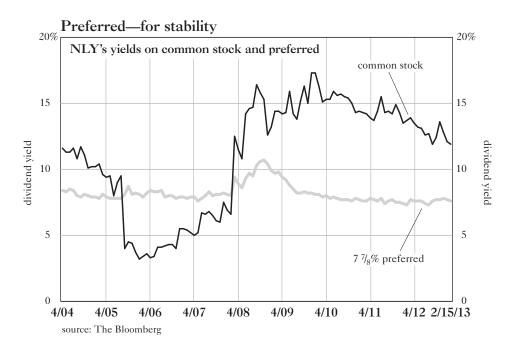


stack up compared to those on agencybacked residential mortgages, "they are comparable returns, but the risk profile is very different. The agency RMBS market is leveraged returns without credit risk as opposed to the commercial market's cash returns with credit risk."

"Here," colleague Evan Lorenz observes, "is an important consideration. Agency mortgages have the full, if unwilling, support of U.S. taxpayers; commercial mortgages can and do go bust. In the fourth quarter, Annaly registered an 11.27% return on equity, after adjusting for unrealized marks in mortgage assets and interest rate swaps (which do not affect distributable income) and a charge for the early extinguishment of debt. Denahan-Norris tells me that she does not intend to use recourse leverage while investing in commercial mortgages. To obtain unleveraged returns above 10%, Annaly would have to lend into riskier tranches of the real estate market. CreXus, as of Sept. 30, invested 69% of its portfolio in subordinated and mezzanine debt and 5% in preferred equity. This is a markedly riskier investment profile than existing Annaly shareholders are accustomed to."

For the second-largest mortgage REIT, American Agency Capital Corp. (AGNC on Nasdaq), the way forward is neither through diversification nor balance-sheet shrinkage (its share repurchases in the fourth quarter were a tiny fraction of Annaly's). The strategy rather remains to seize the day in agency RMBS, management says, the Fed and QE3 notwithstanding. On the Feb. 8 earnings call, officers of AGNC insisted that operating conditions have actually improved in the wake of QE3. Yes, the central bank's massive purchases have narrowed the difference between mortgage yields on the one hand and conventional mortgage financing rates on the other. But the Fed's very overbearing presence has opened a new, low-cost financing opportunity. Taking one thing with another, Christopher J. Kuehl, senior vice president for agency portfolio investments, told dialers-in that "when you overlay the extremely attractive financing rates available through the roll market, current margins are actually wider."

A "roll" is a forward transaction that involves a special kind of mortgagebacked security. It is the kind that



doesn't vet exist but will soon come into being. Such imminent assets trade in a market called the TBA (they will be announced). The initiating party to a roll transaction agrees to sell the current month's TBA at today's price and buy it back at a lower price next month or the month after. The difference between the two prices (the "price drop") is economically equivalent to the net interest income one earns by buying a mortgage-backed security, financing it with a repurchase agreement and holding it on balance sheet. What commends today's roll market, Kuehl said, is that it's cheaper, but no riskier, than repo financing.

AGNC has been on a different kind of roll. In each of the past four years, it has produced accretion in shareholder value—dividends paid plus growth in book value—in excess of 28.2% for an average of 34.4%. Over the same span, Annaly has produced annual accretion of as much as 38.8% (in 2009) and as little as 6.8% (in 2010), for an annual average of 19.2%. Certainly, AGNC has lately been nimbler in picking apart the federal agency market to identify the best risk-adjusted returns.

Prepayment risk is a case in point. American homeowners enjoy an inalienable right to refinance their mortgages at 100 cents on the dollar. At last report, Annaly's book was valued at 103.8 cents on the dollar, and AGNC's at 105.6 cents on the dollar. A glance at those respective marks would suggest that AGNC has the greater exposure to

opportunistic homeowners getting out from under high interest rates by refinancing into low-rate loans.

On the contrary: In the fourth quarter, AGNC showed a constant prepayment rate of 10%, compared to 19% for Annaly. The secret? Anticipating an acceleration in prepayments, AGNC paid for mortgages that exhibited a lower risk of refinancing. Active management is the key, Gary Kain, chief investment officer of AGNC, advises Lorenz: "We feel that it is a specialty of ours so we feel we can maintain our business model and keep it attractive when other people may have trouble."

In the stock market, active management has yielded—how to put this diplomatically?—mixed results. Is it more apt to bear fruit in the mortgage market? To ask the same question differently, is the market in residential MBS so much less efficient than the market in equities? Is it sufficiently inefficient to afford the opportunity for consistent outperformance? We guess not. Some may outperform for a season. A very few may outperform for many seasons. But dependable, "consistent" outperformance over the long sweep of time? An investor may hope for it but not expect it. Certainly, he or she should not pay for it.

In the stock market, AGNC is valued at 103% of book and yields 15.3%. Annaly is quoted at 99% of book value and yields 11.9%—a not unreasonable disparity, we think. At year-end, Annaly was leveraged at 6.5:1 times, up

from 6.0:1 in the third quarter. AGNC was leveraged at 8.2:1 times, up from 7.0 in the third quarter. Indeed, Denahan-Norris told analysts on the fourth-quarter call that were it not for the share repurchases and losses stemming from mortgage prepayments, leverage would have remained at 6.0:1 times. AGNC ratcheted up intentionally.

"We were surprised," Kain tells Lorenz, "that the mortgage market gave back so much of [its] gains given the magnitude of the Fed's program, so we felt that it was a temporary opportunity to incrementally raise leverage a little bit rather than reduce it." Probably, Kain adds, leverage over the next six months will be materially lower "as the Fed's program really starts to eat into the outstanding amount of mortgages."

How to invest to support the aforementioned charities, retirees or lazing about heirs? Lorenz has noticed that Annaly's preferred shares yield more than usual in comparison with its common shares. "In 2005 and 2006, as the yield curve contracted and briefly inverted, the Annaly 7⁷/₈% preferred held its value better than Annaly's common shares," he relates. "Today, the 7⁷/₈% yields 7.6%, or 426 basis points less than Annaly's common. One year ago, the preferred yielded 629 basis points less than the common; 7.4 million shares of the 7⁷/₈% stock are outstanding. A serial preferred issuer, Annaly also has outstanding 18.4 million shares of 7¹/₂% preferred and 12 million shares of 75/8% preferred, both of which are priced to yield 7.6%.

"AGNC's 8% preferred came into the world in March 2012 and is priced to yield 7.7%, or 761 basis points less than the common," Lorenz continues, and "6.9 million preferred shares are outstanding. For Annaly and AGNC alike, interest coverage is a function of the yield curve: the steeper the curve, the more redundant the coverage. For each company, not just any trip-and-fall caliber accident would likely interrupt full and timely preferred payments. Thus, Annaly paid \$19.7 million in preferred dividends last quarter and generated net income before unrealized losses of \$700.5 million. AGNC paid \$3 million in preferred dividends last quarter and generated \$810 million in net income before unrealized securities losses."

Mortgage REITs, leveraged jugglers of abstruse financial risk, will never be everyone's cup of tea. Business development companies, plain-vanilla lenders to companies too small to access either the junk-bond or leveraged-loan markets, deliver lower yields than the REITs with a fraction of the REITs' leverage. Golub Capital BDC (GBDC on the Nasdaq) is one of the better type (*Grant's*, Nov. 2).

Thanks to the falling of the Obama tax ax on Jan. 1, Golub had a strong fourth quarter, booking new loans of \$262.2 million, up from \$113.4 million in the third quarter. Net of repayments, investments were up by \$95.4 million in the year-end period vs. \$36.3 million growth in the Sept. 30 quarter.

"As expected, our yield pipeline in the first quarter of 2013 is much slower than it was last quarter," David B. Golub, CEO of the eponymous lender, announced on the earnings call. "It's not anemic. We're still getting some deals done, but there is no question that we and others in the market are feeling the pull-forward effect of last quarter. We remain cautiously optimistic that new-deal flow in 2013 is going to improve in the coming months; the reason for that is fundamentals. We think the fundamentals remain strong for an increase in M&A activity, and that includes a slow, but improving economy, historically low interest rates, strong appetite among businesses for growth through acquisitions, and private equity firms looking to deploy plentiful capital commitments."

Non-accrual assets totaled 0.3% of the portfolio in the final quarter, down from 0.5% in the third calendar quarter. Some 47% of Golub's assets were committed to so-called one-stop loans, which combine senior and mezzanine credits—33% were in senior secured loans, 11% in second-lien loans, 6% in subordinated debt and 3% in equity. If interest rates should happen to rise, Golub wouldn't be ruined: 89.9% of its loans are the floating-rate kind.

The fourth calendar quarter dividend, at 32 cents a share, was unchanged from the third quarter, while Dec. 31 book value, at \$14.66 a share, was up by 13 cents a share from the year-earlier reading—it seems that the Fed hasn't yet got around to buying up business loans.

Also cheering is the trail of insider purchases of Golub stock by Golub directors spending their own after-tax dollars. It's the sincerest form of financial self-expression.

Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.
Copyright ©2013 Grant's Financial Publishing Inc. All rights reserved.