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Yield times four

Pending the return of the 6% Treasury bill yield, savers need something besides consolation and a Social Security check. What they need is income—safe, dependable and (to the extent possible) lavish. In short, they need what the world can't supply.

Next best alternatives is the subject under discussion. The risks and rewards of a handful of income-producing vehicles are the featured points of focus. Nominees include a trio of mortgage real estate investment trusts and a commercial property REIT. American Capital Agency Corp. (AGNC on the Nasdaq), Capstead Mortgage Corp. (CMO on the New York Stock Exchange) and Annaly Capital Management (NLY on the NYSE) constitute the mortgage REIT quorum; Blackstone Mortgage Trust (BXMT, also on the NYSE) stands alone in the commercial REIT category. For the bearer of a businessman's risk, each of the four has something to offer (as do the business development companies featured in the prior issue of *Grant's*).

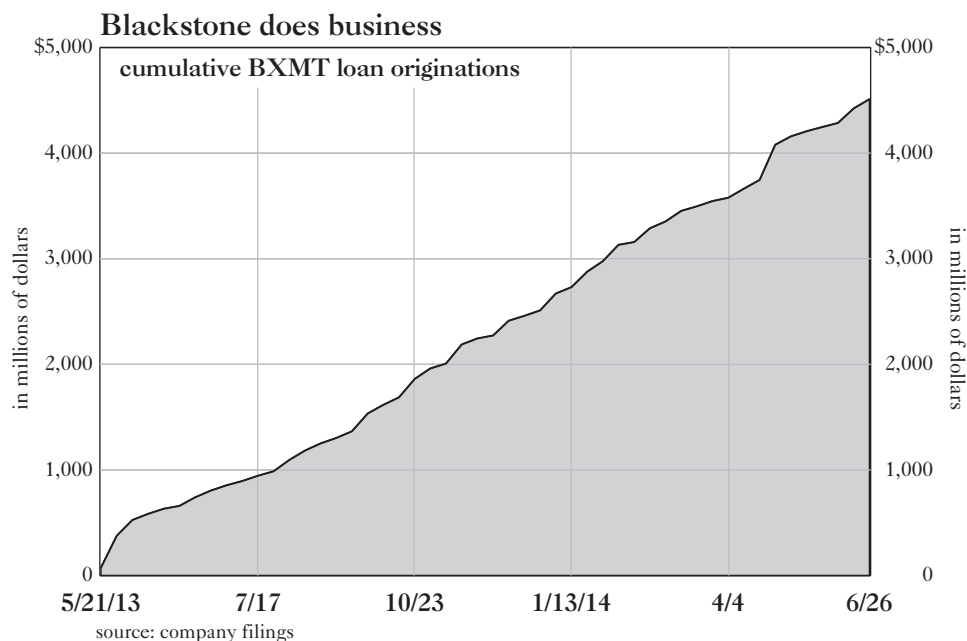
A refuge against plunging stock prices is one perhaps timely attribute of the REITs. NLY and AGNC, in particular, would find themselves in a position to report unrealized gains in book if the bond market continued to rally. Then, again, under the heading of the Great Law of Compensation, higher bond prices would deliver lower mortgage rates, which would, in turn, crimp lending margins. And if bond prices don't continue to rally? If the world doesn't fall apart, the Fed does tighten and interest rates end their 33-year decline? Then CMO and BXMT would be the havens of choice.

Depend on it—not one of these high-yielding investments could work its magic without leverage. Some use more, others less, but all have recourse to borrowed funds. The income they produce is thus not certain but contingent. It depends on Fed policy, the shape of the yield curve, the nature of the assets under management and the hedging strategies of the managers. When adversity strikes and/or the front office miscalculates (as even the best do), dividends get cut and book value takes a licking.

Then, too, mortgage REITs invest with the volatility inherent in the assets they buy. Because the American homeowner may refinance at will (not you, Ben Bernanke), mortgage-backed securities are volatile, options-laden

instruments. When interest rates go up, their duration lengthens. When interest rates go down, their duration shortens. When you want them to leave the portfolio, they stay, and when you want them to stay, they go. Long-dated, fixed-rate mortgages are inherently the most unstable; short-dated, floating ones, the least so.

First up for discussion is the Blackstone entry, the non-mortgage REIT, on which constant readers have already been briefed (see the issues of *Grant's* dated April 18 and Nov. 29, 2013). BXMT lends against income-producing real estate: office buildings, hotels, apartment buildings. It has lent \$4.5 billion since its May 2013 equity capitalization. Its forte is the kind of bespoke financing that the



commercial mortgage-backed securities market—a now-thriving presence in commercial lending—can't accommodate. Is a certain transitional property in need of a new lobby after the mortgage financing closes? Blackstone would be happy to help.

BXMT borrows \$2 for every dollar of equity, a pittance by mortgage-REIT standards. It earns a net interest spread of two percentage points and lends at 65% to 70% of net asset value. It pays a 50-cent per-share quarterly dividend. It trades at \$27.13 a share, a 6% premium to second-quarter book value; the indicated dividend yield is 7.4%.

Colleague David Peligal asked BXMT's president, Stephen Plavin, to compare and contrast Blackstone's M.O. with that of the typical mortgage REIT. "We are generating strong returns without a lot of leverage," Plavin replied. "Our balance sheet is term-matched, index-matched and currency-matched. The most important distinguishing characteristic of our balance sheet versus an agency mortgage REIT [i.e., a REIT that holds mortgage assets guaranteed by Fannie or Freddie] is that our assets and our liabilities are floating-rate, Libor-indexed. Our core earnings and our ability to pay dividends improve with increases in short-term interest rates. We don't have the issues that the residential mortgage REITs have—that when rates rise, their assets become less valuable and they lose book value. We are not vulnerable to prepayment speeds. These are huge differentiating factors."

Do you wonder what the president of a mortgage REIT would say about the business model of a commercial property REIT? At Peligal's invitation, Gary Kain, president and chief investment officer of AGNC, unburdened himself. He said he would rather buy safer assets using more leverage than riskier ones using less leverage. He pointed out that, with abundant liquidity, financing is easy to come by today; it will not always be so. "Let's face it," Kain went on, "when it comes to things either like commercial credit or high-yield credit, the number one risk variable tends to be the availability of financing. There are no defaults when you can easily refinance anything, and anyone can raise money whenever they need to. But financing availability changes very quickly."

To the list of risks that Blackstone confronts, we would add the cen-

REIT vital signs* (in billions of dollars)

name	p/b	leverage	div. yld.	mkt. cap.
Annaly Capital Mgmt.	86%	5.3x	10.6%	\$10.7 bil.
American Capital Agency	87	6.9	11.3	8.1
Blackstone Mortgage Trust	106	2.0	7.4	1.5
Capstead Mortgage Corp.	100	8.5	10.7	1.2

*data as of June 30

sources: The Bloomberg, company reports

tral-bank-induced inflation of commercial real estate values. Lending at 70% of a natural NAV is different from lending at 70% of a puffed up NAV. Blackstone doesn't inflate the NAVs—that's the monetary mandarins' doing—but it has no choice but to do business in the world of suppressed cap rates. Probably, management is well aware of the fact.

AGNC is the second-largest mortgage REIT, behind Annaly. It owns \$72 billion's worth of federal agency-backed residential mortgage securities, which it mostly finances with repurchase agreements (68% of the funding) and equity (13% of funding). The balance sheet is leveraged 6.9:1. At a price of \$22.94, the shares change hands at 87% of June 30 book value; they yield 11.3%.

AGNC is the performance star of the REIT firmament; or, rather—a key distinction—has been the performance star for upwards of six years. In comparison to a \$20 per-share IPO price in May 2008, the company has distributed dividends of \$28.91 per share. Adding changes in book value to dividend distributions has delivered a cumulative overall return of 175.9%, or 18% per annum through June 30. In the total-return department, some years have been better than others, naturally. The range is up 60.6% in 2009 to down 12.5% in 2013.

Kain is an advocate of active management. He reasons that the variability of mortgage prepayments alone demands it. Because the mortgage market is ever turbulent, the favored strategy of one calendar quarter may well prove to be the dog of a subsequent quarter. You have to keep your hands—i.e., his hands—on the dials. Can he twist them as profitably in the future as he has in the past? Nobody knows. It will take some artful twisting to pull off the feat.

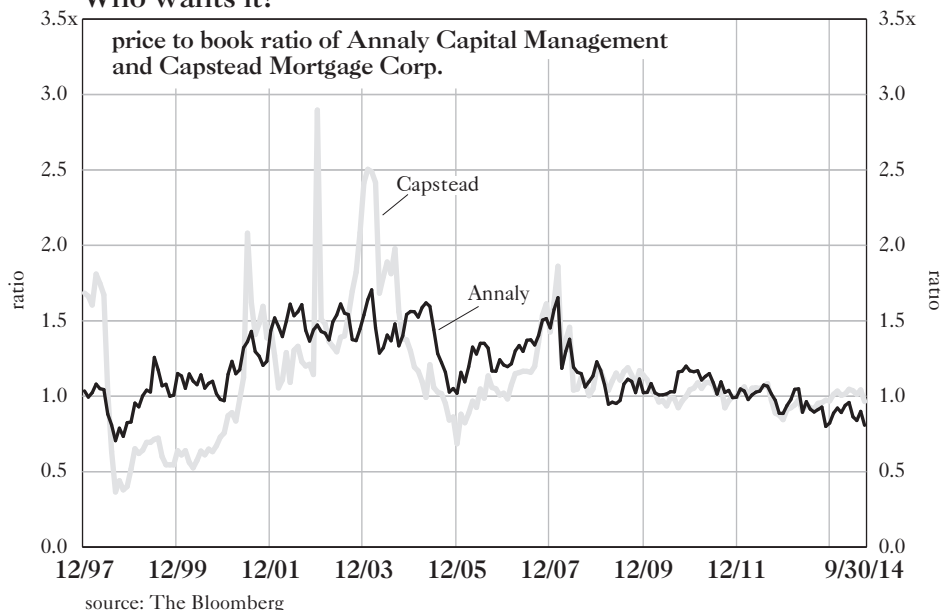
One of the many likable features of AGNC is its management's candor in addressing the shareholder-dubious institution of the external management company. "As most of you know," Kain told attendees at the company's first annual investor day on Oct. 1, "there is an economic incentive for the external manager of firms such as ours to grow rather than shrink. The reality is that the fees we received are based on shareholder equity. Share buybacks reduce shareholder equity and our fee base." So when AGNC repurchased 10% of its shares in 2013 and another 1% in the first six months of 2014, management was thinking of something besides its own net worth. Other policies, too, are calculated to please the investors. Thus, starting on Halloween, AGNC will begin to distribute dividend payments once a month, rather than quarterly. Estimates of NAV, too, will be forthcoming monthly.

On now to the smallest, and yet the oldest, of the three mortgage REITs we named above. Founded in 1985, Capstead (CMO on the NYSE) holds short-duration, adjustable-rate mortgages. ARMs reset with changes in market interest rates. When they reset quickly enough, and are managed adroitly enough, the stockholders enjoy a safer and smoother ride than do the holders of the mortgage REITs that, like AGNC and Annaly, manage mainly fixed-rate, long-dated bonds.

Capstead trades at book value, rather than at a premium to book (like BXMT) or at a discount to book (like AGNC and NLY); plainly, the market approves of the way it does business. The shares yield 10.7%. The balance sheet is leveraged 8.5:1, much more than Blackstone or the other two mortgage REITs. Short-dated ARMs are built for leverage, management contends.

Capstead lived the adjustable-rate dream in 2013. "Our agency REIT peers

Who wants it?



responded to this environment with dividend cuts, portfolio write-downs and outright asset sales, resulting in reductions in book values ranging from 16% to 35%. . . ,” CEO Andrew Jacobs reminded his fellow stockholders in the 2013 annual report. “We came through this period relatively unscathed, maintaining our quarterly dividend at 31 cents per common share, not selling any of our mortgage investments and opportunistically replacing portfolio run-off at attractive levels. Our book value did decline by 8.2%; however, only 5.8% of this decline was portfolio and hedge instrument related. . . .”

For us, that relatively small dent to book value constitutes a salutary reminder of the risks inherent in any leveraged financial structure. There may come a time when (for reasons not now revealed) a floating-rate portfolio leveraged 8.5:1 is just what the market doesn't want. In the spring of 2013, this publication sang the praises of Hatteras Financial Corp., a mortgage REIT that owned adjustable-rate mortgages (*Grant's*, May 17, 2013). Just the thing, we

wrote, to protect net asset value in that time of heightened bond-market volatility. What we did not correctly intuit was that Hatteras' mortgages would not adjust fast enough to protect book value against a coming taper tantrum (which proved to be right around the corner). So we will be careful to characterize the Capstead balance sheet not as bulletproof but as bullet-resistant.

Jacobs is keen on loans that, though they initially pay a fixed rate, presently convert to floating rate. Some convert after five years, others after seven. A five-year, adjustable-rate mortgage is known as a 5-1 ARM—after year five, the interest rate is adjusted once a year.

“We stay on the very short end side,” Jacobs tells Peligal. “We buy 5-1 loans and 7-1 loans. But they're seasoned. They're about 3.5 to four years to the reset date. So when we say we buy these kind of hybrid, longer-to-reset bonds, what we're saying is that within a very short period of time, not five years or more, these things are going to be performing just like they're a one-year ARM.”

Jacobs is eager to remind the world that because Capstead is internally managed, “growth for the sake of growth doesn't motivate me, doesn't incent me, doesn't do anything for me. If I raise capital, it's because I can put it to work in assets I want to be buying. That's why I do it. We basically turned away \$2 billion or more while everybody else was raising.” Laudable, it is.

Annaly, which *is* externally managed and which *is* immense, is also cheap and out of favor. At \$11.33 a share, the stock changes hands at a 14% discount to June 30 book value. Leverage stands at 5.3:1 (very much on the low side for Annaly), and the dividend yield at 10.6%. Among the 22 analyst opinions that Bloomberg posts, five are “buys,” three are “sells” and 14 are “holds.”

To read Mr. Market's lips, the old gentleman is muttering something about an upcoming Fed tightening cycle. Wellington Denahan, CEO of Annaly (who alone among the CEOs with whom we touched base has recently written a big personal check to buy stock in the company he or she leads), has another theory on the NLY share price. She says that the price is depressed because the stock is liquid. It's a handy chip to lay down on a prospective adverse change in monetary policy. “We're victims of our transparency and our liquidity,” Denahan tells Peligal, “and after five years at the zero bound, investors are positioning for a meaningful change in interest-rate policy and the sector's book values clearly reflect that.”

The last time Annaly was as cheap on a price-to-book basis was the year 1998. In the five following years, the shares delivered a total return of 290%. “If you look back historically,” Denahan says, “these periods tend to present opportunities for investors.”

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