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The price is wrong

Looking into the open mouth of the gift horse QE, we see premolars, molars, incisors and canines. The teeth somehow remind us of Oskar Morgenstern (1902-77), a pioneer in game theory and among the wisest of the early quants. "Without the notion of price," Morgenstern propounded, "there would be no economic science."

If so, Bernanke-era economic science is an impostor. Prices there are, of course—Wal-Mart is loaded with them—and many are honest and freely arrived at. Wall Street is different. On the street where we live, prices, increasingly, are federally administered. It's hard to know where one stands.

We think we have a pretty good idea. Investors, financiers and financial analysts do business in a governmentally constructed funhouse. The interior décor features unconventional mirrors. Concave and convex, they make weak credits seem strong and strong credits seem invincible. They impart a beatific luster to common stocks.

Though the mirrors change how things look, they can't change what things are. They can make a short yield look taller but they can't make that illusion pay cash. Which fact brings us back to the universal thirst for income and to the corporate structures that exist to slake it. Business development companies and mortgage REITs are the featured subjects.

The Bank for International Settlements, the central bankers' own Swiss bank, is out with a new quarterly letter that identifies some of the troubles with ultra-low interest rates. You wouldn't have guessed that Europe was in trouble these past

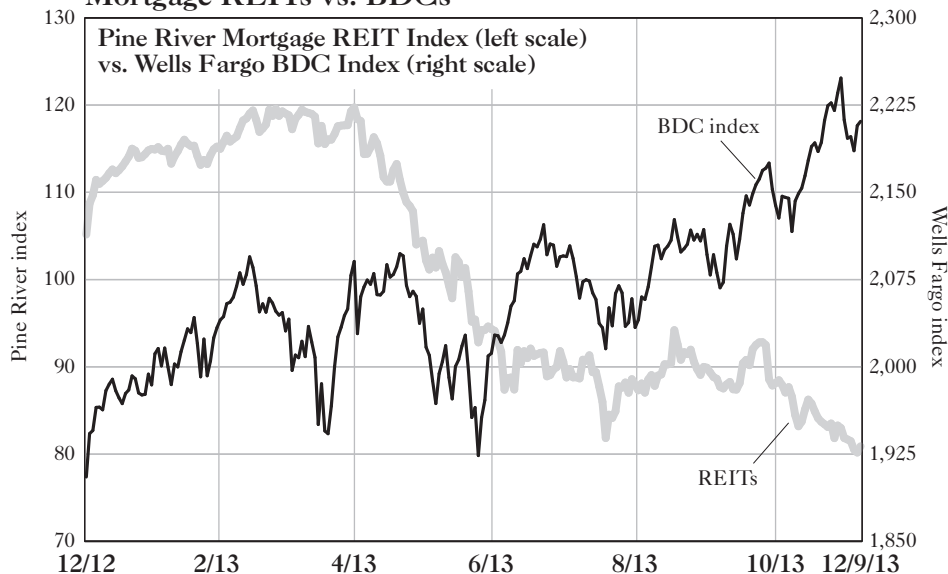
two years by the looks of European credit spreads, the analysis points out; they were quoted as if for prosperity. "Similarly, credit spreads in emerging markets dropped between late 2011 and mid-2013, just when local economic growth showed clear signs of weakness," the report goes on. "This suggests that investors' high risk appetite may have been boosting credit valuations in capital markets, keeping a lid on default rates."

Is a heightened appetite for "risk" behind the mispricing of credit? Or is it the demand for the income that the slow-motion economy of 2013 can't produce by natural means but must manufacture through leverage? We say that people define risk according to what they need to get ahead in life.

It doesn't help the cause of analytical clarity when what they need depends so much on what the Federal Reserve may, or may not, impart.

Suspense concerning the intentions of the imminent new Fed chairman especially weighs on mortgage real estate investment trusts. The two biggest of the kind, Annaly Capital Management and American Capital Agency Corp., have suffered share-price markdowns of about 30% this year. They are quoted to offer dividend yields of 13.7% and 15.8%, respectively. Each changes hands at 78% of book value, which, for each, is a near-record low valuation. The S&P 500 quickly shook off the taper-related jitters of May and June. Not so the mortgage REITs, dealers in the volatile essences of mortgage

Mortgage REITs vs. BDCs



source: The Bloomberg

optionality. (For chapter and verse on the nature of mortgage-backed securities and of the REITs that own them, please drop into the *Grant's* archives, available to every paid-up subscriber at www.grantspub.com.)

Business development companies are another department of the yield fabrication industry. You'll recall that they invest in, and lend to, middle-market businesses. They lend at floating rates tied to the London interbank offered rate, typically with a floor of around 100 to 125 basis points. In theory, BDC-generated yields are safer and steadier than the kind produced by the mortgage REITs. Certainly, they are lower. Mortgage REITs are leveraged 5:1 or 6:1 these days. BDCs, regulated under the Investment Company Act of 1940, may not apply leverage greater than 1:1 in their basic business line.

But there are loopholes, and through these perfectly lawful escape hatches, the BDCs have been branching out and leveraging up. Not all of this diversification and borrowing is brand new. But ZIRP, QE and Twist seem to have sped up its tempo. In the past five quarters, yields on new middle-market loans have compressed by 75 to 100 basis points, David B. Golub, CEO of the eponymous Golub Capital (GBDC on Nasdaq; *Grant's*, Nov. 12, 2012), tells colleague Evan Lorenz. Then, too, Golub says, "Middle-market M&A activity was extraordinary in the fourth quarter of 2012, as owners sought to complete transactions prior to tax rates rising. This was followed by a predictable lull in activity in the first half of 2013. Activity has picked up some since then, but overall 2013 has been a slow year for new buyouts." How do BDCs compensate?

Golub is stepping up leverage. In the quarter ended Sept. 30, the company used 64 cents of debt for every dollar of equity. "Based on GBDC's current asset mix," Golub related on the third-quarter earnings call last week, "we've said previously, and we believe now, that the right target for economic leverage is about one-to-one, and we plan to get much closer to this in the December quarter and beyond."

Business development companies vs. mortgage REITs in millions of dollars

<u>name</u>	<u>mkt. cap.</u>	<u>div. yld.</u>	<u>price/bk.</u>	<u>ytd. perf.</u>
Golub Capital BDC Inc.	\$778.2	7.1%	118.2 %	12.5%
Fifth Street Finance Corp.	1,287.4	10.8	94.0	(11.2)
Prospect Capital Corp.	3,171.6	11.9	104.1	2.7
Apollo Investment Corp.	1,973.2	9.1	105.8	5.0
Annaly Capital Management Inc.	9,663.5	13.7	78.0	(27.4)
American Capital Agency Corp.	7,767.0	15.8	78.0	(30.1)

source: the Bloomberg

Other BDCs have spread their wings. "Thus," Lorenz reports, "Prospect Capital Corp. (PSEC on the Nasdaq) owns a private multi-family REIT that was established in 2010, an airport food and concession business purchased in 2010, an installment-loan company with a specialty in financially strapped borrowers purchased in 2012 and a buyer of auto loans from a network of 800 used-car dealers purchased in February. As to that installment lender to the needy, it's a '30-ish percent APR business,' management says, not—not—to be confused with the infamous, 300-ish percent APR business of payday lending."

A third BDC, Fifth Street Finance Corp. (FSC on the Nasdaq), on the defensive after a disappointing June quarter, announced a five-point recovery plan. The acquisition of Healthcare Finance Group, a lender to small and midsize healthcare companies, was one of these initiatives. Notably, HFG shows a ratio of assets to equity of 16:1. Another item on the remediation agenda was a rotation into high-yielding assets.

"On Sept. 19," Lorenz relates, "Fifth Street issued 17.64 million shares at \$10.31 a piece. Investors took heart: Here was an expression of confidence in the five-point stratagem. After all, management wouldn't risk its credibility by selling stock two weeks before closing out a bum quarter. So you can imagine the market's surprise when Fifth Street proceeded to disclose a drop in net income and a cut in the annual dividend to \$1 a share from \$1.14 a share. The stock today fetch-

es \$9.25 a share. Maybe the plan will work better next quarter."

"Although underlying fundamentals remain sound," Edward J. Goldthorpe, president and CIO of a fourth business development company, Apollo Investment Corp. (AINV on the Nasdaq), told dialers-in on the company's Nov. 8 earnings call, "we believe the abundance of liquidity and search for yield continues to result in the mispricing of risk." Goldthorpe hit the nail on the head, though one might quibble about his use of the word "fundamentals." To us, the overriding fundamental fact of present-day credit is the ever-present, almost irresistible temptation to stretch for yield. It is deeply unsound.

In general, BDCs change hands at a premium to book. Golub, among the best-reputed of the group, trades at 118% of book. Yields range from as little as 7.1% for Golub to 10.8% for Fifth Street and 11.9% for Prospect. The mortgage REITs, as noted, languish at deep discounts. By our reckoning, Annaly and AGNC have likely discounted anything except a sudden and violent upside lurch in yields—say, to 3.75% or 4% on the 10-year Treasury. To judge by the insider accumulation of stock since Sept. 30, Annaly's management (and to a lesser extent, AGNC's management) concur.

As between the known risks of the mortgage REITs and the perhaps less well understood risks of the BDCs, we'll take the former. It's not that the risks of mortgage investing aren't clear and present. The point is that, at current valuations, the mortgage REITs are paying you to bear them.

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