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## The votes are in

Along with Mitt Romney and Paul Ryan, the invisible hand had an election to forget. Even so, the market is pricing an assortment of mortgage REITs as if the Republicans won—with the price mechanism riding victorious on their coattails—and as if the Democrats lost. Following is a look at some potentially mispriced securities.

Redwood Trust (RWT on the New York Stock Exchange) was—so one would have thought—a Romney stock. A special kind of mortgage real estate investment trust, Redwood buys prime jumbo loans from private mortgage originators. It securitizes them and sells them, all but the higher-yielding, first-loss slice, which it retains. In effect, Redwood is the anti-Fannie Mae and the anti-Freddie Mac of American mortgage finance.

It has seemed a quixotic market niche. The government today is responsible for nine out of 10 mortgage originations—given the formidable regulatory barriers to competing with the U.S. mortgage apparatus, one might have supposed it would be doing 10 out of 10. Yet Redwood, which in 2010 issued the first free enterprise, residential mortgage-backed security of the post-Great Recession era (*Grant's*, May 14, 2010), has subsequently issued seven more. As for 2012, with five deals totaling \$1.7 billion in the books so far, it's shaping up as the fifth-busiest year in the company's 14-year history.

The business plan is simple, Martin S. Hughes, Redwood's CEO, advises colleague Evan Lorenz. In a world of falling interest rates and a superabun-

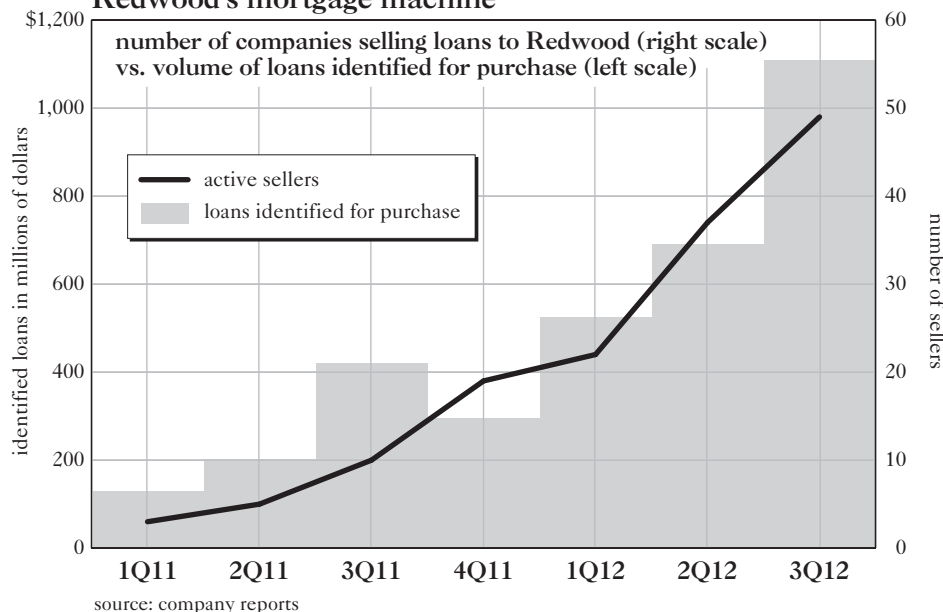
dance of liquidity, people need the safe and sound kind of income that carefully underwritten jumbo mortgages provide. As for representations of safety and soundness, Redwood has earned them. Cumulative losses borne by investors in the \$36 billion of securitizations the company has issued since 1997 sum to the grand total of 57 basis points, according to an analysis by Jefferies & Co.

From a low of \$9.79 last year at this time, the shares have rallied by 60% to \$15.42. The yield famine has helped to raise them up, of course, as has the recovery in house prices. A third contributor to the enrichment of the Redwood shareholding base is the good work done by the acting director of

the Federal Housing Finance Agency, Edward J. DeMarco.

DeMarco has been at the FHFA helm since James B. Lockhart III stepped down in August 2009. "A non-political appointee," Lorenz relates, "DeMarco has charted a non-political course to bring the disgraced federal mortgage behemoths, Fannie Mae and Freddie Mac, to heel. He has done this in several ways. For instance, he has reduced the upper limit on so-called jumbo agency loans to \$625,500 from a post-crisis maximum of \$729,750. He will have increased the fee that the agencies charge to guarantee mortgages to an average of roughly 48 basis points at year-end from 26 basis points in 2010. Sensibly, he has proposed

Redwood's mortgage machine



## Redwood Trust—a bet on enterprise



to raise the guarantee fee in states in which foreclosures are long and drawn out—the Democratic stronghold of Illinois, for instance. DeMarco's grand design is to turn Fannie and Freddie into low-risk utilities from the powder kegs they were."

How refreshing are these reforms, one may reflect. And then, on further reflection, how much greater a chance would DeMarco have of succeeding in a Romney administration. Quoth Democratic minority leader, Nancy Pelosi, in an Aug. 1 press release: "Acting Director Ed DeMarco has undermined the health of the housing market and jeopardized the economic security of our middle class." Seconded *New York Times* columnist and Nobel Prize winner in economic science, Paul Krugman, a couple of days later: "President Obama, if re-elected can, and should, replace him [DeMarco] through a recess appointment. In fact, he should have done that years ago."

The same sword that hangs over DeMarco's head also proverbially hangs over Redwood's share price. An Obama-compliant FHFA director would likely not raise guarantee fees and might well roll them back. He or she might consider raising the upper limit on jumbo agency loans. Nor is it likely that the administration's pick to succeed DeMarco would choose to penalize the state of Illinois for taking its own sweet time in pushing delinquent mortgagors through the foreclosure pipeline.

Hughes laments what he calls a regulatory Catch-22. Because private finance has been largely driven from the mortgage market, the conviction gains credence that it couldn't, and therefore shouldn't, be allowed to reenter it, he says. It becomes self-fulfilling: "You're just going to go on and on if you never give the markets a chance to develop. You will never get out of the circle. What I think that our deals are demonstrating is that private capital will come back to financing well-underwritten prime mortgages. We're doing it one deal at a time. We'll do probably six or seven deals this year.

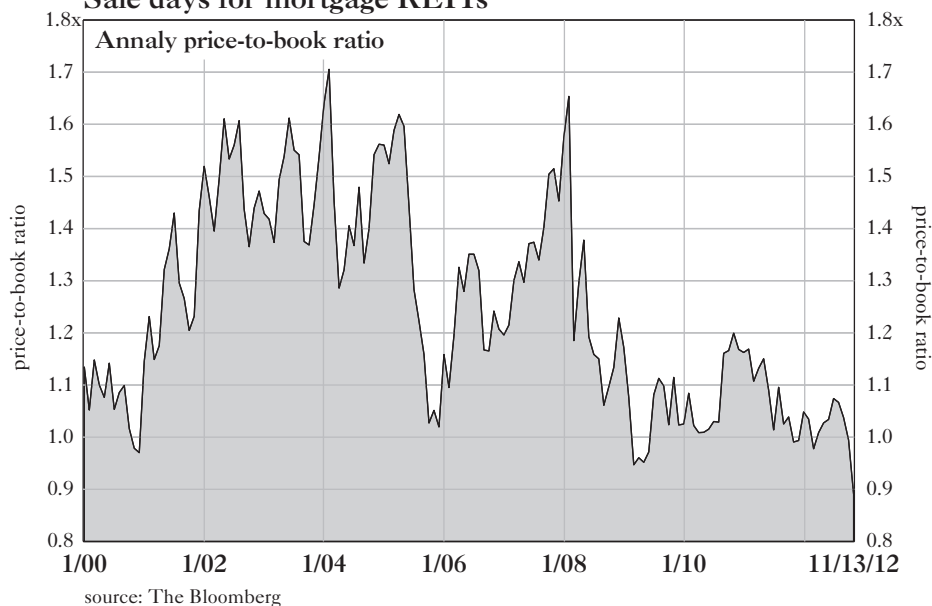
Our volume just continues to increase. If the government continues to dominate the market, then there's really no need for private capital. But it's slowly changing, with guarantee fees going up, loan limits coming down. It's giving us some runway, and we are doing our best to demonstrate, hey! the private market is working."

Redwood is leveraged 4:1 according to GAAP. It is leveraged 1:1 according to what we judge to be the substantive economics of the situation. (The difference has to do with the treatment of structured credit instruments sold to third parties. Consolidate them on the balance sheet of the originator, the Financial Accounting Standards Board commands. Be that as it may, Redwood retains no economic interest in the RMBS it sells to others.) According to GAAP, Redwood's balance sheet foots to \$5.3 billion. According to GAAP-with-a-grain-of-salt, our preferred metric, it foots to \$1.9 billion.

Since the financial crisis, management has branched out into the commercial real estate-lending business. It made a big, opportunistic and well-considered investment in orphaned non-agency MBS from third parties (a trove that, at the end of the third quarter, was valued at \$985 million). To date in 2012, Redwood has returned 12.4% on equity, up from 2.7% in 2011, 10.8% in 2010 and 6.2% in 2009.

Mr. Market has affixed his seal of approval on the Redwood share price. Quoted at 120% of book value, RWT

## Sale days for mortgage REITs



is trading near the upper end of its post-2000 valuation range. We have two things to say about Redwood the stock, as distinct from Redwood the business, or—especially—Redwood the dauntless champion of enterprise in mortgage finance. The first thing is that RWT is a Romney stock in the time of a non-Romney administration. The second thing is that the Redwood share price is rich in comparison to what one might call Obama stocks.

The conventional mortgage REITs are, in a sense, Obama stocks. They need the federal agencies and the mortgage-backed securities that the agencies issue and guarantee. What they emphatically do not need is the Federal Reserve paying uneconomic prices for agency MBS in order to implement QE3, but that is a slightly different matter. “Priced at a discount to book,” Lorenz points out, “the mortgage REITs seem to be discounting the Fed’s intervention. Redwood, priced at 120% of book, is not discounting the government backsliding on Fannie and Freddie reform.”

So, then, what does one do for income? Ares Capital and Golub Capital BDC (*Grant's*, Oct. 19 and Nov. 2, respectively) meet with our approval, though we are rooting the stock prices lower on behalf of any who do not own the shares but wish to buy them. After their recent thumping, we like the mortgage REITs. Hatteras Financial Corp. (HTS) is valued at 85% of book to yield 12.7%; American Capital Agency Corp. (AGNC) at 91% of book to yield 16.9%; and MFA Financial (MFA) at 88% of book to yield 10.8%. Each has its own M.O., strengths and foibles; for a survey, see the April 6 issue of *Grant's*.

Our old friend Annaly (NLY) instituted a \$1.5 billion share-buyback program on Oct. 16, a rarity, if not a first, for a mortgage REIT. The shares are trading at 89% of book to yield 13.8%. Is this not a clarion call to income-seeking bargain hunters?

Perhaps, but there’s a catch. On Monday, Annaly announced a tender offer for Annaly-managed and 12.4% Annaly-owned CreXus Investment

Corp. (CXS), the parent’s underachieving investor in commercial real estate-related loans. The price Annaly is prepared to offer, \$12.50 a share, represents a 5% premium to CreXus’ stated book value.

Where does this leave the holders of NLY? Management declines to comment on the CreXus tender. We note, however, that Chimera Investment Corp. (CIM), the parent’s other underachieving public subsidiary, is quoted at 83% of book. Annaly owns 4.38% of the outstanding shares, and the Chimera market cap is \$2.77 billion. On Monday’s news of the CreXus tender offer, the Chimera share price rallied by 8.6%; it fell back by 2.5% on Tuesday. Where Chimera should trade on the merits is a little hard to say inasmuch as the company, beset by accounting problems, hasn’t reported earnings since the third quarter of 2011. Let us just say that Annaly has its hands full.

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