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## Pole-vault yields

In the first quarter, falling mortgage-backed securities prices dented the book value of two of the biggest mortgage REITs, while a third mortgage REIT, tiny by comparison, sailed through almost un-dinged. Which of the three is the best candidate to continue to deliver yields in the low to mid-double digits—seemingly impossible yields in this world of ZIRP—is the topic at hand.

Falling MBS prices were likely not what the Fed intended when it bought up as many as \$40 billion of agency-backed securities in each of the first three months of the year. Yet fall those prices did. Annaly Capital Management (NLY on the Big Board), which had \$125.5 billion under its wing, suffered a 4.2% loss of book value; American Capital Agency Corp. (AGNC on the Nasdaq), which managed \$93.4 billion, bore a loss of 8.5%; and Hatteras Financial Corp. (HTS on the New York), the steward of a mere \$26.1 billion, absorbed a reduction in book value of just 0.03%.

Constant readers will recall how mortgage REITs generate income: They use leverage to transmute debt instruments yielding less than 3% into REIT shares yielding many times more than 3%. On its face, this is a worrying proposition. Mortgages are perverse kinds of instruments, bundles of options that are about as stable as the average 16-year-old boy. Yet leveraged portfolios of MBS have delivered enormous returns. From 2001 to 2012, Annaly produced average annual returns of 20%, returns defined as dividends plus change in book value divided by the previous year's book value. Clearly, Annaly—under the management of

the late Michael A.J. Farrell and of the very much living Wellington Denahan-Norris—did not achieve these extraordinary results by rolling Treasury bills.

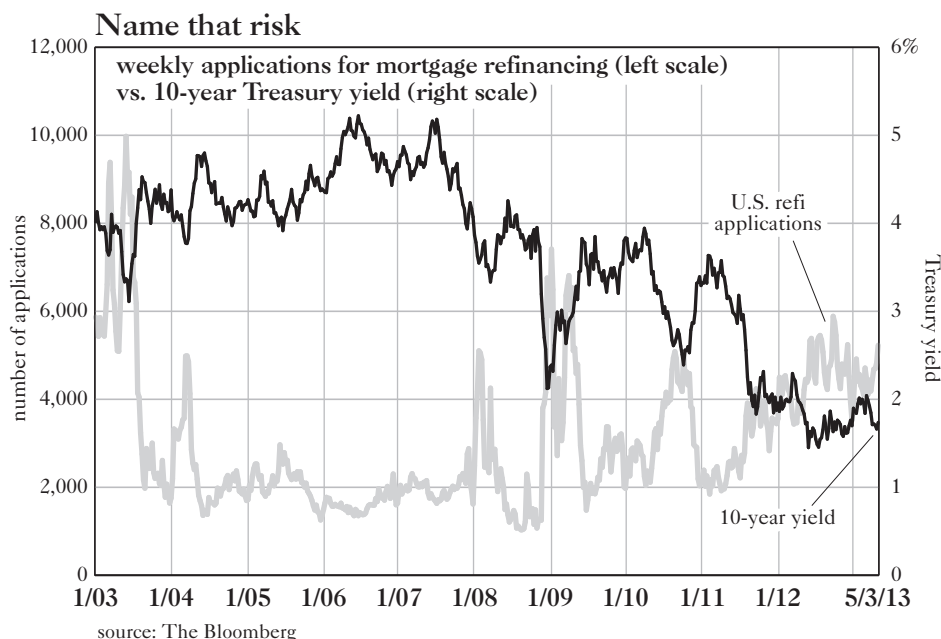
In America, mortgage borrowers enjoy the right to refinance, which means that mortgage lenders have the duty to bear the costs of refinancing. It follows that mortgage lenders can suffer torments whether interest rates are falling or rising.

When rates are falling and bond prices are rising, homeowners refinance (assuming they can qualify for a new loan, no sure thing these days). So instead of enjoying the bull market, creditors must scramble to replace the assets they lose to refis. It can be just as vexing when interest rates are rising. Now homeowners don't refinance,

and creditors are stuck with mortgages they wish they didn't have.

So it's prepayment risk in a bull market and extension risk in a bear market. How a mortgage REIT manages the reciprocal perils, juggling liquidity and leverage and counter-party risks all the while, determines how much income it can safely throw off and how secure and stable its book value will be.

Look at the first quarter. AGNC, which has delivered some of the best returns of any mortgage REIT since it started in 2008, had positioned itself to protect against early repayments by paying a premium for ref-insulated securities (*Grant's*, Feb. 22). But rising interest rates shifted the market's focus to extension risk from



prepayment risk and dealt the aforementioned knock to book value.

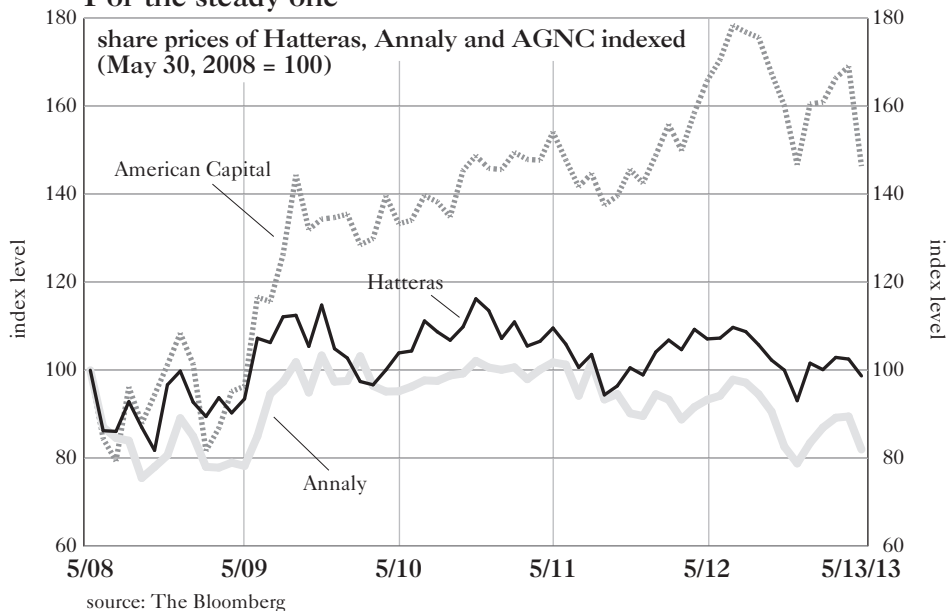
That was then, however, AGNC president and chief investment officer Gary D. Kain told dialers-in on the company's May 3 earnings call. "The global growth picture has weakened again and inflation expectations have declined," said Kain. "As such, a midyear tapering or a QE3 exit now looks unlikely. Against this backdrop, interest rates have come back down and mortgage valuations have strengthened." Besides, Kain advises colleague Evan Lorenz, Japanese buyers have stepped up the gait of their buying of U.S.-guaranteed mortgages since the Bank of Japan launched its yen-printing program on April 4.

"At first glance," Lorenz notes, "AGNC and Annaly look a lot alike. Fixed-rate securities make up 86% and 92% of AGNC's and Annaly's respective portfolios. Both companies make heavy use of swaps and other instruments in an attempt to lock in the spread between assets and liabilities. For Annaly, hedges were equal to 46% of the investment portfolio; for AGNC, 73% of the investment portfolio. The disparity in hedging was, to a degree, offset by a disparity in leverage: Annaly piled \$6.60 of debt on every dollar of equity to AGNC's \$8.10 of debt on every dollar of equity."

But AGNC and Annaly are anything but identical. For one thing, AGNC is more inclined than Annaly to make tactical portfolio shifts, as in paying premium prices to guard against mortgage prepayments. Then, too, Annaly is striking off in a strategic direction very different from AGNC's by starting to substitute credit risk for interest-rate risk.

Thus, on May 23, Annaly will absorb CreXus Investment Corp., its publicly listed subsidiary that invests in commercial real estate securities. Annaly can place up to 25% of its capital (*not* its assets) in these credit-sensitive claims, which, unlike the emissions of Fannie Mae or Freddie Mac, have no backstop at the Treasury. "While CreXus, with assets of less than \$1 billion, is of no particular significance today," Lorenz points out, "the parent seems intent on ramping up exposure to commercial loans. On May 1, Annaly announced seven new hires to assist

### For the steady one



CreXus's existing management team."

On Annaly's first-quarter conference call, Denahan-Norris took issue with the criticism some observers have leveled at the mortgage REITs lately (critics who include Fed Governor Jeremy C. Stein and the collective anxious voice of the Financial Stability Oversight Council). Yes, she acknowledged, the REITs do manage lots of assets, and they have grown like topsy. But they—i.e., the surviving REITs, of which Annaly is the largest and most seasoned—have proven their mettle. They have dealt with the 2003 refi wave, the 2004-06 Fed tightening, the 2008-09 six-alarm fire and today's set of peculiar difficulties, including the combination of ultra-low interest rates and sky-high mortgage prices and a central bank that uses MBS as a kind of policy battering ram. This, too, will pass, she said in so many words.

Well, we can't be positively sure, which brings us to our third featured stock. Headquartered in Winston-Salem, N.C., Hatteras is different. The head man, Michael R. Hough, earned \$1.6 million in 2012, compared to \$25.8 million for Denahan-Norris (and \$32 million for her late co-CEO, Mike Farrell). There is an implied institutional modesty, too, in the way Hatteras manages its portfolio. To minimize interest-rate risk, Hough & Co. hold adjustable-rate

mortgages (89.6% of the portfolio as of March 31), with the balance in 15-year agency MBS. While ARMs do adjust to changes in interest rates, they do so with a lag. To bridge the temporal gap, Hatteras deploys swaps equal to 46% of its assets. In the first quarter, as noted, Hatteras stood out, its book value dipping by only a penny a share, to \$28.27. Management loaded \$7.40 of assets on every dollar of equity.

"We are concerned with what the yield curve is going to do and what interest rates are going to do," Hough tells Lorenz. "What would it take for a change to happen unexpectedly? I do think that the Fed will do their best to telegraph what they are going to do. But the market is going to price a strengthening economy or a Fed pullback from QE pretty quickly and pretty aggressively. These are the kinds of moves that we have to be careful with."

Annaly, AGNC and Hatteras, different though they are, all trade at around book value. Mr. Market mutely judges that Hatteras's 10.7% yield is economically equivalent to AGNC's 17.3% yield and Annaly's 12.2% yield. Each REIT takes measured risks to conjure yield. The best balance between risk and reward at the current iffy juncture? We'll take Hatteras, the modest little one.

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