Winter Symposium, March 5 2013 - Mortgage REIT Summary

By Vadim Elenev and Stijn Van Nieuwerburgh

The conference began with a presentation by Marc **Bell**, General Partner at Barbican Capital and Co-Founder and Board Member of Armour Residential REIT Inc. and Javelin Mortgage Investment Corp. **Bell** defined REITs, described their various types, and discussed recent performance and future prospects. Stijn **Van Nieuwerburgh**, Professor of Finance and Director of the Center for Real Estate Finance Research at NYU Stern, followed with an analysis of Mortgage REIT equity returns over the last 40 years.

To qualify as a REIT and thus be exempt from corporate tax, **Bell** explained, a company must pay out at least 90% of taxable income as dividends, invest 75% of its assets in real estate, and derive 75% of its income from real estate. The first REITs were all Equity REITs, who own or operate properties and collect rent. Since the 1980s, there has been growth in Mortgage REITs (mREITs), who issue mortgages, buy mortgages, or buy MBS, and receive interest payments. Lastly, Hybrid REITs engage in both activities. Mortgage REITs are typically levered through short-term repurchase agreements, depending on the types of mortgages they hold. Agency mREITs such as Annaly Capital Management (Annaly), American Capital Agency Corp (AGNC), and Armour Residential REIT, Inc. (Armour) invest primarily in MBS guaranteed by a government-sponsored entity (GSE) and hence bear only interest and prepayment risk. Non-agency mREITs, such as Redwood Trust, invest in privately issued MBS, and also bear credit risk. Hybrid mREITs, such as Chimera Investment Corp., invest in both types of residential mortgages. Lastly, Commercial REITs, such as Starwood Property Trust, invest in privately issued commercial MBS.

Over the past 40 years, **Van Nieuwerburgh** said, mREITs as a whole have underperformed the stock market, earning 2.2% annual returns with 20.6% annual volatility, while the stock market earned 5.7% return with 16% volatility. Over the past 20 years, this underperformance is due to the weak performance of non-agency and commercial REITs, both in absolute terms and after adjusting for their exposure to risk factors such as stock and bond market returns. In contrast, agency mREITs have significantly outperformed the market, earning 16.3% annual excess return. This result is largely driven by agency mREITs robustness during the recent financial crisis and large growth since. As a result, agency mREITs feature prominently (9% allocation) in an optimal portfolio. Van Nieuwerburgh showed that mREIT returns can be predicted to some extent, and historical predictability patterns suggest about 4% expected returns for 2013.

Since the financial crisis, Mortgage REITs have grown faster than the S&P 500, **Bell** pointed out. As GSEs continue to wind down their portfolio of agency MBS and as the Fed joins them after the termination of quantitative easing, the private sector must step in to prevent a decline in mortgage supply. He estimates that the private sector must fill a $1 trillion gap over the next 5-7 years. Mortgage REITs are uniquely positioned to take that role because of their expertise and dedication to this asset class, and so face an opportunity for growth over the next decade. Additionally, the current low yield environment makes high dividend yield assets, like REITs, especially attractive.

Two panel discussions followed, addressing the effect of monetary policy on mREITs, their role in a revival of private securitization, and housing finance reform. The first panel consisted of Jay Diamond (Managing Director and Chief of Research at Annaly), Wayne Passmore (Associate Director Research and Statistics, Board of Governors of the Federal Reserve System), Matthew Jozoff (Managing Director at JP Morgan), and Mark D. Hanson (Senior Vice President and Head of Securitization at Freddie Mac). The second panel consisted of Scott J. Ulm (Co-CEO of Armour), Gary Kain (President and CIO of AGNC), Philip Harris (Partner at Skadden), and Bose George (Managing Director Equity Research at Keefe, Bruyette & Woods).

JP Morgan's Matthew **Jozoff** noted the significant impact that the Fed's decisions have had on the price of agency mortgage-backed securities, mREITs' raw material. Investors anticipated QE3 by buying securities, and then sold when it was announced. In fact, government policy expectations rather than fundamentals are driving the market, according to Freddie Mac's Mark **Hanson**. Armour's Scott **Ulm** and AGNC's Gary **Kain** agreed that the Fed's program was sure to have a large impact for the foreseeable future. Yet there are always opportunities for well-positioned firms, **Kain** said, since hedging has become better and easier. Annaly's Jay **Diamond** pointed out that both continuation and termination of the QE3 poses risks to the industry, but is something the Fed is aware of. Like **Bell**, Bose **George** of Keefe, Bruyette & Woods saw an opportunity for mREITs when the Fed joins the GSEs in reducing their agency portfolios.

Diamond praised Fed governor Jeremy Stein for investigating the impact of its monetary policy on various asset classes, including Mortgage REITs. The spectacular growth of mREITs in recent years does not signal overheating, he said, but rather is a success story for private capital return to mortgage finance. mREITS already decreased their leverage ratios. While they don't have the safety net of deposit financing, they already meet Basel III requirements and have worked to lengthen their liabilities. **Kain** agreed, pointing out that mREITs are much less levered than GSEs. Furthermore, there hasn't been reaching for yield, according to **Ulm** and **George**.

George further noted that investors are more aware of the risks than they used to be, and mREITs now trade in a narrow price-to-book window. Wayne **Passmore** pointed out and **George** agreed that while valuations may be correct, it is crucial for mREITs to disclose their exposure to interest rate risk in more detail than they have. **Diamond** defended Annaly's transparency, describing the scenario analysis and stress testing reported by Annaly in its quarterly filings and presented in conference calls. **Kain** said that AGNC is also transparent, allowing investors to run their own projections on top of the ones it discloses.

The panelists commented on mREIT's potential role in reviving private securitization in light of **Van Nieuwerburgh**'s observation that non-agency REITs underperform the market and agency REITs. A rise in private securitization would require not only investors to hold credit risk, but for banks to use their portfolios to finance mortgages, **Passmore** noted. **Jozoff** expects most of the growth to remain on the agency side. New regulations for banks encourage investment in liquid assets. **Diamond**, **Kain**, and **Ulm** all pointed out that while investor appetite for non-agencies exists, repo funding for non-agency assets is available only with large haircuts. After collapsing asset values prevented some non-agency mREITs

from rolling over their repo liabilities during the crisis, today non-agency leverage is attained only through structuring, **Diamond** said.

The revival of private mortgage finance need not solely happen in non-agency. **Hanson** observed that, prior to conservatorship, GSEs were both guarantors and investors. But their current mandate is to reduce exposure not just to interest risk but also to credit risk. Depending on what securities GSEs issue, REITs could take on credit risk within an agency framework, according to **Hanson**. **Kain** agreed, but pointed out that GSEs would prefer to use derivatives to sell credit risk, while mREITs would rather buy senior subordinated tranches. The distinction between agency and non-agency cannot be reduced to interest rate vs. credit risk, **Kain** added, since today's non-agency mortgages still carry interest and prepayment risks. According to **George**, strong underwriting standards mean credit risk is less of a worry now than it used to be, and that the focus should be on interest risk as GSEs reduce their portfolio. A way for the government to stimulate a return for private securitization, **George** continued, would be to increase the price of the credit guarantee.

Philip **Harris** of Skadden put in context SEC's recent examination of mREITs's potential similarity to mutual funds. mREITs are exempt from the Investment Company Act, which regulates mutual funds and, among other requirements, restricts leverage, but that exemption hinges on substantial "interest" in real estate. The definition of this interest, especially as it applied to securitized loans, has changed over time. Currently the SEC is gathering information, but has no plans to act. Significant restrictions are unlikely, **Harris** claimed, because Congress remains in favor of mortgage finance. **Ulm** pointed out that mREITs have top standards in corporate governance and transparent reporting, the Investment Company Act's main goals. While mREITs are levered, it's unclear what too much leverage is. **Ulm** appealed to the SEC to be mindful of the mREIT business model, since it is sensitive to the SEC's asset regulations.

Going forward, the panelists offered their preferred housing finance reforms. **Hanson** praised qualified residential mortgages (QRMs) as a tool that will properly align incentives while maintaining risk sharing. **Jozoff** noted that new bank regulations increase the disparity in regulation levels between different types of financial institutions, and encouraged policymakers to consider regulation's impact on the comparative balance between various players. In this context, the rise of mREITs is good because they are less concentrated than other unregulated entities. **Diamond** cautioned against a reduction in GSE guarantees, noting the potential real effect on housing prices if private capital doesn't make up for a government retreat. **Passmore** stressed the need to address how crisis/tail insurance is managed by the government, given that investors will continue to expect governments to step in. One change the panelists did not favor was a move away from the 30-year fixed rate mortgage, with **Jozoff**, **Hanson**, and **Passmore** expressing support for the status quo in this dimension.

Overall, the conference provided a comprehensive discussion of the mortgage REIT universe and brought many crucial players together to discuss the effect of current and future monetary and regulatory policy on mortgage REITs, with an emphasis on the important role mortgage REITs can play in a revival of private mortgage finance.