A Preferred Way to Generate Yield - Part 2 Trade Idea

The following article expands on, *A Preferred Way to Generate Yield*, by exploring the preferred shares of Government Guaranteed Agency-Backed Mortgage Real Estate Investment Trusts (REIT) and discussing a compelling trade idea within this sector. Neither the common nor the preferred equity classes of this style of REIT are widely followed, which helps explain why the opportunity of relatively high dividends without excessive risk exists.

What is a Mortgage REIT?

Real estate investment trusts, better known as REITs, are companies that own income-producing real estate and/or the debt backing real estate. REITs are legally required to pay out at least 90% of their profits to shareholders. Therefore, ownership of REIT common equity, preferred equity and debt requires that investors analyze the underlying assets and liabilities as well as the hierarchy of credit risks and investor payments within the capital structure. The most popular types of REITs are called equity REITs (eREIT). They own apartment and office buildings, shopping centers, hotels and a host of other property types. There is a smaller class of REITs, known as mortgage REITs (mREIT), which own the debt (mortgage) on real-estate properties. Within this sector is a subset known as Agency mREITs that predominately own securitized residential mortgages guaranteed against default by Fannie Mae, Freddie Mac, Ginnie Mae and ultimately the U.S. government. The main distinguishing characteristic between eREITs and mREITs is in their risk profiles. &#2013266080;The shareholders of eREIT securities primarily assume credit risk associated with rising vacancies and declining property values. Most mREITs, on the other hand, take on less credit risk. Instead, their dividends are largely based on interest rate risk or the yield spread between borrowing rates and the return on assets. Agency mREITS that solely own agency guaranteed mortgages take on no credit risk. Mortgage and equity REITs frequently employ leverage which enhances returns but adds another layer of risk.

Mortgage REIT Capital Structures

MREIT?s use debt, common equity, preferred equity and derivatives to fund and hedge their portfolios. Debt is the largest component of their capital structure, often accounting for more than 75% of the financing. Common equity is next in line and preferred equity is typically the smallest. The REITs choice of financing is generally governed by a balance between cost and desired leverage. When a REIT issues common or preferred equity, leverage declines. Conversely, when debt is employed, leverage rises. The decision to increase or decrease leverage is often a function of balance sheet preferences, hedging strategies, market views and the respective costs of each type of financing. The choice between preferred and common is frequently a function of where the common stock is trading versus its book value as well as the financing costs and liquidity of the two options.

Selecting Agency mREIT Preferred Shares

Agency mREIT (again holding predominately government-guaranteed mortgages) preferred shares currently offer investors a reasonable return with manageable risk. In the current environment there are two primary reasons why we like preferred securities versus their common shares:

- Discount to Book Value- Currently, several of the Agency mREITs that offer preferred alternatives are trading at price -to- book values below 1.0. While below fair value, we are worried shareholders might get diluted as they are at or near levels where new equity was issued in the past. We prefer to buy the common shares at even deeper discounts (in the .80?s or even .70?s) for this reason. Discriminating on price in this way offers a sound margin of safety where the upside potential is enhanced and risk of new share issuance diminished.
- Interest Rate Risk- The Fed is raising rates and the yield curve is generally flattening. Profitability of mREITs is largely based on the spread between shorter-term borrowing rates and longer-term mortgage rates. As this differential converges, mREIT profitability declines. Also, as mentioned in our Technical Alert ? 30 Year Treasury Bonds, longer-term yields might be reversing a multi-decade pattern of declining yields. While the funding spread is a key performance factor, rising yields introduce complexities not evident in a falling rate environment. Namely, hedging is more difficult and asset prices decline as rates rise. While we still think probabilities favor lower yields, a sustainable break in the long-term trend must be given proper consideration as a risk.

Before selecting a particular REIT issuer and specific preferred shares, we provide a list of all Agency mREIT preferred shares that meet our qualifications.

RIA Pro	Issue	Ticker	Maturity Type	Coupon	Current Price	Call Price	Next Call	Yield	Yield to Call	Yield to Worst
Invesco Mortgage Capital	IVR 7 1/2 PERP	IVR/PC	PERP/CALL	7.500	24.40	25.00	9/27/2027	7.684%	7.770%	7.684%
Two Harbors Investment	TWO 7 5/8 PERP	TWO/PB	PERP/CALL	7.625	25.80	25.00	7/27/2027	7.389%	7.278%	7.278%
Two Harbors Investment	TWO 8 1/8 PERP	TWO/PA	PERP/CALL	8.125	26.69	25.00	4/27/2027	7.611%	7.396%	7.396%
Two Harbors Investment	TWO 7 1/4 PERP	TWO/PC	PERP/CALL	7.250	24.71	25.00	1/27/2025	7.335%	7.433%	7.335%
Invesco Mortgage Capital	IVR 7 3/4 PERP	IVR/PB	PERP/CALL	7.750	25.56	25.00	12/27/2024	7.580%	7.404%	7.404%
Annaly Capital Management	NLY 6 1/2 PERP	NLY/PG	PERP/CALL	6.500	24.17	25.00	3/31/2023	6.723%	7.253%	6.723%
AGNC Investment	AGNC 7 PERP	AGNCCN	PERP/CALL	7.000	26.03	25.00	10/15/2022	6.723%	6.034%	6.034%
Annaly Capital Management	NLY 6.95 PERP	NLY/PF	PERP/CALL	6.950	25.50	25.00	9/30/2022	6.814%	6.466%	6.466%
Annaly Capital Management	NLY 8 1/8 PERP	NLY/PH	PERP/CALL	8.125	25.59	25.00	5/22/2019	7.939%	4.567%	4.567%
AGNC Investment	AGNC 7 3/4 PERP	AGNCCB	PERP/CALL	7.750	25.52	25.00	5/8/2019	7.593%	4.410%	4.410%

Data Courtesy Bloomberg As shown in the Yield -to- Worst column (far right), the lowest expected yields are somewhat similar for all of the issues with five or more years remaining to the next call date. To help further differentiate these issues, the table below highlights key risk factors of the REITs.

RIA Pro	Ticker	Leverage Mulitple	Price to Book Value	Price to Book Value -5yr Range	1 Year Interest Rate Sensitivity	3 Year Interest Rate Sensitivity	Pfd. As % of Total Equity
Invesco Mortgage Capital	IVR	7.78	0.91	1.03 - .57	6.13	1.60	12.75%
Two Harbors Investment	TWO	7.27	0.94	1.04 - .72	1.33	3.54	14.08%
AGNC Investment	AGNC	8.47	0.95	1.06 - .72	5.42	6.39	5.79%
Annaly Capital Management	NLY	7.18	0.98	1.18 - .73	1.70	5.54	13.02%

Data Courtesy Bloomberg The bullet points below describe the four factors in the table:

- **Leverage Multiple**- This is the ratio of total assets to common and preferred equity. Higher leverage multiples tend to result in bigger swings in profitability and the potential for a reduction in common and preferred dividends. It is important to note that leverage can change quickly based on the respective portfolio managers view on the markets.

- **Price -to- Book Value (P/B)**- This is the ratio of the market capitalization of the common stock to the value of the assets. As the P/B approaches fair value (1.00) the odds increase that common or preferred equity may be issued, putting shareholders at the risk of dilution. The column to the right of P/B provides context for the range of P/B within the last five years.
- **1 and 3 Year Price Sensitivity**- This measures the change in book value as compared to the change in U.S. Treasury yields over selected time periods. This is an indication of hedging practices at each of the firms. The lower the number, the more aggressively they are hedging to protect against changes in yields. This measure, like leverage, can change quickly based on the actions of the firm?s portfolio managers.
- **Preferred as a Percent of Total Equity**- This metric offers a gauge of the percentage of preferred shares relative to all equity shares. Preferred shareholders would rather this ratio be small. However, if the number is too low versus competitors, it might mean that preferred shares will be issued soon which would temporarily pressure the price of existing preferred shares.

Trade Idea

Given the current interest rate volatility and the potential for large binary moves in mortgage rates, we think Two Harbors Investment Corporation (TWO) appears to present the least overall risk based on the measures above. In particular, we are focused on their aggressive hedging strategy which has resulted in the lowest interest rate sensitivity over the one and three year time periods. A

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mREIT Common Stock Comparison since 2016		
mREIT	Total Return	Sharpe Ratio
Invesco (IVR)	14.06%	0.786
Two Harbors (TWO)	12.91%	0.824
AGNC Inv. (AGNC)	6.44%	0.393
Annaly Cap. (NLY)	5.98%	0.333

Data Courtesy Bloomberg

We are largely indifferent between the preferred issues of TWO (A, B and C) shown in the first table. The investor must choose between a preference for a higher coupon and a price above par ($25), and a lower coupon but price below par. On a total return basis, they yield similar results. *TWO spun off Granite Point in the fourth quarter of 2017 and therefore data related to that transaction was adjusted in the table to compensate for the event.*