



*Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2008 first quarter earnings call. We reprint those remarks below:*

### **“To Serve Man”**

As fans of The Twilight Zone will recall, “To Serve Man” is the tale of the arrival on earth of seemingly kind and generous 9-foot tall beings from another planet, the Kanamits. These giant aliens arrive in peace, promising only to help humans enjoy a better life. As they share their advanced thinking, technology and methods, it is clear that they can quickly solve all of the impediments to progress on earth. They eliminate hunger, disease, greed and, as a result, the need for war. Even the most skeptical among earth's citizens are converted particularly after the title of one of the Kanamit's books is translated. After all, the title of the book— “To Serve Man”—clearly sets forth the benevolence of their mission.



As the story moves ahead, massive numbers of satiated, complacent citizens of earth begin to line up eagerly to travel on the alien space ships to the Kanamits' home planet, a virtual risk-free paradise. It is so wonderful there, apparently, that no one ever wants to return to earth.

In the final scene, the remaining skeptic on earth is carried away screaming by the crowd. You see, he has finally analyzed and cracked the rest of the code in the alien's book. “To Serve Man” is not a book of instructions on how to assist mankind; rather, it is a cookbook with instructions on how to make earthlings complacent, fatter and healthier for slaughter and consumption.

I think it is appropriate to compare this Twilight Zone episode with the past several years of credit complacency, financial engineering and capital markets feeding the global consumer's desire for a better life.

In retrospect, the 2002-2007 credit criteria for underwriting debt could have just as easily arrived from another planet. The cookbook was the computer models designed to financially fatten up the credit cycle by making below-investment grade cash flows suitable for mass consumption and thereby curing the hunger for a better life with a no-money down, low equity lifestyle. Instead of an encoded book, the recipe was locked in inscrutable offering documents and flawed models that were blessed by overmatched ratings agencies, over-zealous underwriters and negligent regulators who didn't understand what the cookbook said. Now that the book has been decoded, the challenge in the markets is to identify the opportunities left in wake of the massive repricing of these cash flows.

As the first quarter came to a close, the financial markets got a chance to watch history unveil itself. The Federal Reserve accelerated its sprint to ease balance sheet stress not only at the banking level, but also at the primary dealer level. With the combination of Bear Stearns, JP Morgan Chase, the Term Securities Lending Facility, the Primary Dealer Credit Facility and the slashing of short term funding rates, the credit markets wobbled through a shaky first quarter's end. Indeed, commercial banks were so stuffed with cash at March 31 that they actually began to direct money away from their balance sheets and into competing money market funds.

In the last weeks of March, I believe we witnessed a preview of the new financial world order. We are now firmly set towards a path of reconstructed underwriting criteria that will be the new Sarbanes-Oxley of the debt and structured finance world. There is a deeply-seated desire for simplicity at every level of banking and investment. This need will be satisfied via long overdue regulatory updates, since many of today's core formulas and calculations were written in the 1930s and only lightly amended or eased over time. This provided numerous chances for financial engineering to push market activities beyond the boundaries of regulatory oversight to the point where we arrived at the wreckage of the last six months.



Where does this leave us? We see disarray and dislocation for many levels of mortgage-backed securities, municipal securities, corporate securities, auction rate preferreds, student loans and asset-backed securities. The Federal Reserve and its international counterparts are taking unprecedented steps in providing liquidity to the system. As evidenced by the experience of cash investors on March 31<sup>st</sup>, the issue is not about liquidity, there is plenty of cash around. It is, however about counterparty pricing, trust and execution. The global consumer, who benefited from the rush to riskless spreads over the past several years, now will be paying the price, in terms of risk adjusted spreads as the trust is rebuilt. This will take two things:

1. A long time to cure
2. A steep yield curve, globally

Welcome to the planet of the Kanamits. The cookbook has been decoded and is being rewritten. The recipes have inalterably changed for corporations, consumers, banks and broker dealers. It is a world where risk premiums have been reintroduced, asset spreads are wider and, as a result, capital is being reallocated. We described this world in the February 5<sup>th</sup> commentary entitled “Welcome to the Keynesian Nightmare”. In the referenced chart in that paper we described the crowding out effect that Government borrowing will have to provide so that the general economy can reflate. Against this background all capital allocators are faced with the judgment call of estimating what will be an acceptable rate of return in a world where the primary competitors for capital are Federal level issuers who can liquefy markets at will, and can print money simultaneously.

The writedowns and the recapitalizations are happening at a faster rate now than ever before in history in the banking sector. A recent JP Morgan research paper tallied the total writedowns so far at \$300 billion and total capital raised at \$200 billion. Every day brings a new announcement of distressed capital raising. Do you think that these bank risk managers, surveying the future course of their businesses, will be seeking more or less risk? More certainty of principal return or more risk based returns?

As investors in Japan have learned since 1987, asset deflation is painful and rates of return on Government-backed debt are nominally lower than one could have imagined 20 years ago. Whether you call it asset deflation or stagflation, all analysis leads to one compelling desire. The need for more alpha in portfolios, along with certainty of principal return. As of March 31, Annaly’s cumulative total rate of return since its NYSE listing in late 1997 was 291%, or 14% on an annual basis. The S&P 500, by contrast, generated a cumulative total return of 71%, or 5.3% annualized. Most of our return has always come from alpha—our dividend. Quarterly dividends where *you* decide how to compound *your* returns.

Come to think of it, John Maynard Keynes was almost as tall as a Kanamit. He peacefully and benevolently espoused deficit spending and debt capital formation in order to jumpstart a recessionary economy. The fact that this theory was adopted and perverted by financial engineers in the private sector as a more or less permanent state of affairs got us into the mess we are in today. Perhaps his book, The General Theory of Employment, Interest and Money, was more a cookbook than we imagined.

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