



Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2007 second quarter earnings call. We reprint those remarks below:

Credit Lessons from 1812

We in the financial markets love to look at graphs. We like to analyze them, learn from them and draw conclusions from them. I want to begin the earnings call today by talking about what we can learn from one of the most remarkable graphs ever drawn. It was created by Charles Joseph Minard, a noted French engineer who was born in 1781 and died in 1870. Many of you may have seen the graph before, and it is reproduced on the last page of the text of my remarks which are posted on our website on www.annaly.com. Just click on the "Commentary" button.

Minard's masterpiece graphically illustrates the terrible fate of the French army during its invasion of Russia, which began in June of 1812. The graph is a multivariate depiction of the decimation of Napoleon's troops during the campaign: It gives a timeline, the direction they marched, the weather conditions, the topography of the land, and the size of the army every step of the way as the troops advanced and then withdrew from tough Russian resistance and brutal winter weather conditions.

The width of the band at the top of the graph represents a vast French army of 422,000 troops, gathered on the Polish-Russian border at the start of their march to conquer Russia. As the graph moves West to East, the band gets thinner because within 100 days, Napoleon reached Moscow with only 100,000 troops left only to discover the city sacked and deserted. As the graph moves back East to West, the band gets thinner and darker as Napoleon and his men retreat back to Poland's borders through the winter of 1812-1813. They made it back with roughly 10,000 men surviving the campaign.

With full comprehension that we at Annaly have often taken heat for our negative take on the credit cycle that had emerged over the past four years, I believe there are lessons to be learned from this chart and comparisons to be drawn metaphorically.

If we use our imaginations to replace Napoleon's troops with the vast army of capital willing to reduce underwriting standards in its chase for yield, we can understand the slow decimation of equity as the credit cycle plays out. Remarkably, the time frame for the march and the destruction of underwriting standards is equally striking. The credit problems first emerged in the capital markets and the media in late February of 2007. Here, in July, a mere 100 days or so later, the capital markets are in full retreat from their 'Moscow.' The retreat is now accelerating and moving towards other credit classes, even sovereign debt as we speak today. We expect, before all is said and done, that full risk premiums will be re-established across the debt and equity universes, and there will be lots of credit-sensitive casualties along the way. If Napoleon was left with just a little over 2 men for every 100 he started with, that sounds about right for the type of capital losses we have seen already and could continue to see in today's credit cycle.

This is not the first time we have seen something like this in Annaly's operating history. In 1997, it was the Asian credit and currency crisis. In 1998, it was the unwinding of leveraged risk premium transactions in the wake of Long Term Capital Management. History has a way of repeating itself, usually by transforming the risks and rewards into new, strikingly dissimilar forms that fool participants into believing, no matter how well-versed or prepared, that 'this time is different.'

I'm not talking just about financial markets. Evidence that the mistakes of the past are repeated can be seen in Europe's military history, just 130 or so years after Napoleon's retreat. In June of 1941, Hitler commenced Operation Barbarosa, the invasion of Russia. Believing that his plan was better than Napoleon's, he centered his attack on Stalingrad. He went in with 3,000,000 troops, 3500 tanks. History shows that 20,000,000 Russian troops and civilians were killed during this action. Like Napoleon, the German army staggered and stalled in the face of a brutal Russian winter.



By early 1942, it was over. Winston Churchill, in praise of the Russian partisans and the military's use of the 'scorched earth' tactics, said that Russia had ripped the heart out of the German military. Today, business history will record that the combination of tightened lending standards, local and Federal government crackdowns and the overshooting of the pricing of the risk premium have ripped the heart out of this benign lending environment and the credit cycle which it created. It will be up to the central bankers of the world to figure out the Marshall Plan needed to reestablish the credit parameters by which prudent growth can be stimulated.

Two years ago, many of you on this call heard us describe the deterioration of the credit-driven economy as a 'slow-motion car wreck.' At the time, the catalyst for this observation was the downgrades of General Motors and Ford by the rating agencies. We described the financing tactics of 'no money down,' interest free loans and lucrative leasing deals as nothing more than short term sales solutions to a bigger economic problem for those companies. The mortgage market is no different. Our car wreck analogy is still accurate, and it gives us no pleasure to report that the sub-prime mortgage market turmoil has it accelerating into the wall as far as we're concerned. Despite the headlines, despite the damage done to the financial sector from a valuation viewpoint, we believe that we are still in the early stages of the wreck and the air bags are far away from deployment, even if the Federal Reserve decides to take any action.

As we discussed last summer, on the 2nd quarter earnings call for 2006, we believe that the Fed is in denial at the magnitude of the logistics facing the broader, consumer-based US economy. They must now know how Napoleon felt, about 70 miles outside of the borders of Moscow. There is a long, cold credit winter settling into the capital markets. Our advice is: Dress appropriately.

Michael A.J. Farrell
Chairman, CEO and President of Annaly Capital Management, Inc.
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