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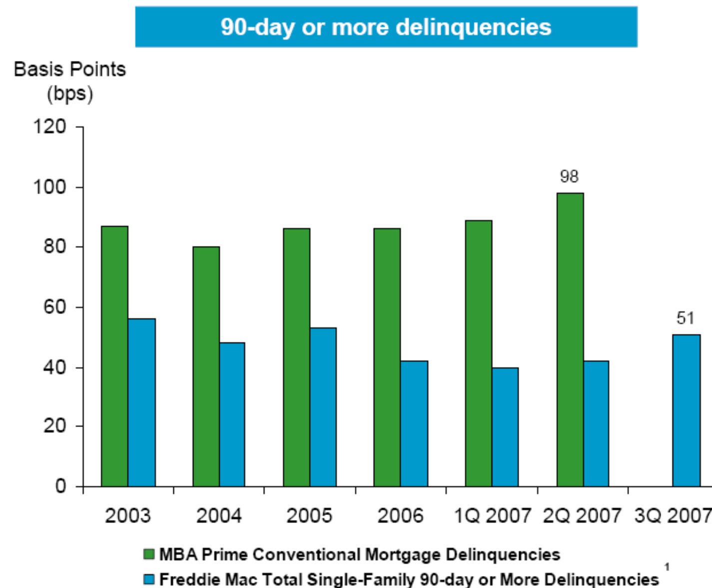
Note on Freddie Mac Following Release of its 3rd Quarter Results

On November 20, 2007, Freddie Mac reported a net loss of $2.0 billion, or $3.29 per diluted common share, as well as a reduction in the fair value of shareholders' equity of $8.1 billion, which had the effect of reducing book value to an estimated $25.25 per share at September 30[1]. Included in the net loss were credit-related expenses of $1.2 billion (including higher provisions for credit losses and real-estate owned expenses), and actual credit losses of $126 million. The $8.1 billion mark-to-market change was largely attributable to spread widening as a result of increased uncertainty related to the general state of liquidity in the credit markets. At the same time, the company announced that it would take steps to shore up its capital position, including looking to raise more capital in the "very near term," slash its common stock dividend by 50% and, if necessary, reduce balance sheet growth or issue additional preferred or common stock. Freddie's common stock, which closed over $63 as recently as October 5, is currently trading around $27.

This was not a particularly surprising release. Neither Freddie Mac nor Fannie Mae are immune to the current market environment. But ***this release is not about credit performance in Freddie Mac's portfolio.*** Total credit losses are still just 3 basis points (0.03%) of its portfolio. Serious delinquencies (90 days or more late) are running at 51 basis points in the third quarter, compared to 98 basis points for the Mortgage Bankers Association index of prime conventional mortgage delinquencies.



Nor is this earnings release about the income statement. Net interest income and guarantee fee income grew in the quarter. The company has pricing power, particularly as the conforming, conventional and prime mortgage market is virtually the only functioning part of the mortgage market. In fact, alluding to the flip side of softer asset prices, the company said investment opportunities are quite attractive with spreads on new investments currently three times as wide as the current portfolio spread.

No, ***this release is about balance sheet.*** At the end of the third quarter the company had core regulatory capital of $34.6 billion, which is $8.5 billion in excess of the regulatory minimum capital requirement and about $600 million above the 30% mandatory target capital surplus directed by OFHEO. Moreover, the company stated that the

[1]Merrill Lynch research report November 20, 2007.

market conditions of the third quarter are continuing in the fourth quarter and are likely to continue into 2008. As a result, the company needs to raise additional capital to meet and maintain its 30% surplus capital threshold through the foreseeable future.

Today's release and the subsequent company conference call, to us, confirm the sea change that has occurred in Freddie Mac's (and Fannie Mae's) attitude towards the market since their regulatory issues began and their old leaders were thrown out. In 2002, we wrote a commentary on Fannie Mae and Freddie Mac[2] in which we said (with emphasis added), "***Fannie Mae and Freddie Mac serve two masters*** with different objectives—the Federal government that chartered and regulates them, and the stock market that looks for growth. The last five years of financial results would lead any observer to conclude that management of these two entities has been listening more to the second master, possibly to the detriment of the first." That was five years ago, and a lot has changed since then. If today's events prove anything, it is that this prioritization of responsibility is no longer true. Freddie Mac's message to the market is that it will dilute stockholders in order to continue to enable the smooth functioning of the mortgage market. Richard Syron, Chairman and CEO of Freddie Mac, articulated the company's dilemma in very blunt terms. He said that he could either turn his company into "Fortress Freddie", in which the company shrinks its business, or he can continue down the path they have laid out today. Either outcome is unpleasant. "Fortress Freddie" would mean that the firm would likely be a seller into the market at a time when the market is looking to the GSEs to provide liquidity, which would not benefit the mortgage market or the economy as a whole. The path they have laid out, on the other hand, will depress returns to shareholders, at least in the short run, but keep Freddie as a more active participant in the mortgage finance process.

Headlines and press releases will continue to affect the trading of the securities of the Agencies. We already see what has happened to their share prices. Agency MBS, as usual, underperform Treasuries, a fact that has not been helped by the challenges of the current credit crunch. But Freddie Mac has chosen wisely to focus on fulfilling its mandate and to shore up its balance sheet. This bodes well for holders of Agency MBS. Freddie Mac stockholders, however, will have to wait.

November 20, 2007
Jeremy Diamond
Managing Director

[2] "A discussion of risk at Fannie Mae and Freddie Mac", June 21, 2002, found at www.annaly.com/commentary.html

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