Annaly 2024 Investor Day
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Agency MBS & Mortgage Servicing Rights

Moderator

Andreas Strzodka, *Head of Macro Strategy*

Panelists

V.S. Srinivasan, *Head of Agency*

Ken Adler, *Head of MSR & Head of Portfolio Analytics*

Andreas Strzodka:

Well, thank you. Thank you, David. My name is Andreas Strzodka. I'm the Head of Macro Strategy and I'm very excited to be moderating this panel today with my two colleagues, V.S. Srinivasan, the Head of our Agency business and Ken Adler, the Head of our Mortgage Servicing Rights business. Now we want to do three things today. The first third we'll spend a little bit about a market overview to see how everything is going right now. We will then speak about what makes Annaly's Agency and MSR businesses unique. And finally we'll talk about some of the synergies between the business. Now to get into the market overview, everybody in this room is aware the US economy remains exceptionally strong. That we expect the growth to come in at 2.75% this year. The labor market has slowed, hiring has slowed somewhat. The unemployment rate has risen off very low levels, but nonetheless, the labor market is in a very good place.

It's roughly in balance between supply and demand, and that should be a tailwind going forward. Inflation has slowed from very high levels. Yes, it remains above the Fed's 2% target because service sector inflation is fairly high. But if I had told anybody two years ago at the peak of inflation that we will get to this point today without seeing a meaningful economic downturn, you would've all laughed me out of the room. So I think things are pretty good on this, and I would just make the other point about inflation is that wages so far have moderated at a slower pace than inflation, and that has really led to positive real income growth for consumers which has fed this economic cycle. Now, I'll talk about housing real quick. So in the housing market, we're basically seeing a market at an equilibrium of very low levels of activity.

Anybody who already owns a home and got a mortgage way back when, has generally very low interest rates and they're locked into their homes right now, unable to move because it would be prohibitively expensive. At the same time, people that want to buy a home, they're facing high housing prices as well as high mortgage rates, which makes it difficult to move. Now we have seen an improvement in the level of inventories are coming off very low levels, but the rise in inventory has been driven by new homes, and it's been predominantly in areas of the south of the United States as well as the West, where it's much easier to build then call it in New York City. And now ultimately I think the outlook for the housing market will be very closely tied to the level of interest rates.

If you look at current market pricing, expectations are for mortgage rates to remain roughly here, which would suggest that the housing market remains roughly stuck. But again, the two will be highly correlated. Now on fixed income markets, I'll just make three quick points. The first one is real interest rates are very high, it's 2.1% 10-year real Treasury rates. So that's closer or more corresponding with the period that we saw before the financial crisis than the area of very low interest rates and very low spreads that we saw between the great financial crisis and the pandemic. I think the second thing is that volatility has been very high.

David talked about this briefly, interest rate volatility has moderated, but it's clearly not yet back to the level where it was in, call it between 2015 and 2019 when interest rate volatility was very low and very good, very

kind to mortgage investors such as ours. And finally, I would just make the point that this year we have been encouraged by the stronger fixed income flows. The demand for fixed income has certainly improved, probably driven by the Federal Reserve. Flows this year, they're running at twice the rate of last year, and they're probably the second-best year in the past 20. So I'll leave it at that. Not to take too much of Mark Zandi's thunder from later on, but let me ask you Srini, what's going on in the Agency market?

V.S. Srinivasan:

Thanks, Andreas. So Agency MBS spreads are attractive both on an absolute basis and relative to other fixed income assets. Over the last two years, there have been two significant headwinds for the sector, elevated interest rate volatility and a supply demand imbalance. And over the last few months, we have made some progress on both fronts. Like Andreas said, the US economy is normalizing. Labor markets are more in balance, inflation pressures are easing, and this has led to a decline in volatility, with fits and spurts. But overall volatility has declined significantly from the peak in say the third quarter of 2023. But vol levels are still pretty high and we expect that without any unpleasant surprises that volatility will continue to decline in 2025, and that should be supportive for spreads. Though, supply-demand imbalance is also easing. In 2023, banks shed about $160 billion in Agency MBS, and so far this year they have added about $75 billion.

So that itself is a $250 billion shift in the supply-demand equation. Andreas mentioned that fixed income flows have been pretty strong and typically a percentage of fixed income flows materialize as demand in the Agency MBS sector. And finally, historically, at least when the Fed embarks on an easing cycle, we have seen increased demand for Agency MBS from both foreign accounts and banks. So overall, we are very constructive on Agency MBS and we think spreads will tighten, particularly if interest rate volatility continues to decline. But what we don't expect is that spreads will go back to the levels you saw pre-COVID. That's the blue line in that chart. And the main reason for that is that the Fed is going to continue to let the Agency MBS portfolio run off even after they stop shrinking the balance sheet.

So that is an additional $180 billion in supply that has to be absorbed by other market participants over and beyond the almost $200 billion in organic growth that we expect in the Agency MBS sector. And this supply from the Fed is going to persist for many years. So we think that puts a floor on how tight Agency MBS spreads are going to get. So let's put some numbers around it. Over the last few months, current coupon spreads to the blended Treasury curve have traded in 115 to 140 basis point range. We think over the next few months this range could tighten to something like 110 to 125 basis point range. This is actually, as David mentioned, a pretty good outcome for us. The potential tightening in market spreads is generally supportive of book value and even at those tighter levels, spreads are wide enough that we can comfortably earn our dividend.

Andreas Strzodka:

Yes, thank you Srini. Ken, how's the MSR market treating you?

Ken Adler:

Well, you heard from Dave, it's been great. MSR investment has created great returns post-COVID, and the reason for those returns are in place today and go forward in our view and big picture, what those reasons are, I think they're pretty straightforward. They're slow prepayments industry-wide, they're low delinquencies and an ample supply of investment. Just to take a step back as to why the opportunity got created. During COVID, interest rates went down, mortgage interest rates in particular, to a point where virtually every homeowner or most homeowners in the United States could benefit from a refinance. As a result of that, mortgage lenders were able to do record volumes at record profit margins, that created the capital for them to retain MSR at a level that historically they've never been able to do before.

David talked about it being a little bit of luck. The rate at which things changed in 2022 certainly was not forecast, but we did foresee, and the reason I joined was seeing this buildup of MSR on non-bank balance sheets and the potential opportunity. So as the environment changed in 2022 and rates went higher, the profitability of these entities declined, they were left with very high fixed cost infrastructures. So in addition to scaling back their operations, MSR was sold to create liquidity. Very straightforward. So why do I say it's still in place today? That's because where interest rates are and where the stock of outstanding mortgages are struck, the likelihood of volumes and margins going to a level where the mortgage industry can economically retain the MSR that's created is just highly unlikely.

And that's really why we're so excited. Annaly is especially well situated because we've created a business where we're a friendly buyer. And what I mean by that is we do not directly compete with sellers. We don't touch consumers, we don't service our own loans, we don't do our own recapture activities, we outsource all of those activities. So all things being equal, people would like to work with us. The other thing that makes us a great buyer is the reliable source of capital. The amount of capital we have allocated to MSR, even at the targets that we've published, is still just a fraction of our capital. So our ability to have a reliable bid in the market and execution is needed because these sellers are relying us on us for liquidity. It's there and it counts and yeah.

Andreas Strzodka:

Thanks Ken. So I think that describes generally a constructive market backdrop. I mean, as in any market environment risks remain, but we do think we're getting fairly compensated to take them. So now let's shift a little bit to our second topic, Annaly's secret sauce. So Srini, let me ask you, how do we manage our Agency portfolio different from other mortgage REITs or similar competitors?

V.S. Srinivasan:

Sure. Compared to our peer group, we have a lot more flexibility in rotating in and out of Agency MBS because we do invest in other asset classes. If you think about the Agency MBS sector, it is very competitive and there are a lot of smart people doing relative value or trades within the sector. And at Annaly we pride ourselves as being able to come up with the best relative value trades. But typically these trades add tens of basis points of alpha.

If you think of relative value trade across sectors, it's a lot less competitive and can often add hundreds of basis points of alpha. So our ability to rotate in and out of Agency MBS to MSR and Resi gives us the ability to capture some of this outsized alpha that can be generated. Now, what gives us that ability? Well, in the base case, we think of Agency MBS at 7.5x our debt-to-equity leverage, our MSR business at 1x and our Residential Credit business at 2x, but we don't always finance it that way. Ken maybe you can elaborate to everybody why the MSR business is always a debt to the Agency business.

Ken Adler:

And we thank you for that. Most participants looking to generate teen sorts of returns in the asset class are applying leverage to the asset, and we are no different, we do that as well. And what differentiates us is our cost of leverage, and Dave mentioned how we manage it at the top of the house, and you're going to hear later from our Treasurer more about the specifics of how that works. The big picture, MSR leverage is SOFR plus hundreds. Agency leverage is SOFR plus single digits. Because we run the Agency business with prudence, there's excess borrowing capacity available there that we can tap and thanks Srini for on the MSR side. Now we're not compromising firm-wide liquidity because we maintain financing lines against our MSR that are committed lines so they can be drawn on very short notice and that borrowing if it was ever needed for another investment opportunity or for whatever corporate purpose. So the blended cost of the leverage allocated to the business is just lower than our peers and provides us substantial competitive advantage.

V.S. Srinivasan:

So as Ken explained, at any given time, we can tap this MSR warehouse and increase our capital allocation to Agency MBS allowing us to grow our Agency MBS book. That's what gives us the ability to rotate in and out of Agency MBS very seamlessly. The diversified model also helps us handle spread volatility much better. So we have about 60% of our capital invested in Agency MBS, and thankfully over the last few years, the episodes of spread volatility in Agency MBS have not been correlated with common commensurate spread volatility in MSR and residential credit. So when spreads widen in an Agency MBS, the losses we take is spread across our entire capital base.

So in effect, we only lose 60% of what we would have lost if we were a mono line Agency MBS portfolio. Now you could argue that Agency MBS spreads go up and down, but locally they generally tend to mean revert. So these are just paper losses, who cares? But it's important to note that these spread widening episodes can be quite significant and prudent risk management demands that at some point you de-lever. It's just that with 60% of our capital and Agency MBS, we have a much longer runway before we hit the threshold where we have to do something. I think this is a very important distinction between us and how we manage our portfolio and how our peers have to manage their portfolio.

Andreas Strzodka:

Thank you guys. So we wouldn't be Annaly if we wouldn't be talking about our scale as the largest mortgage REIT. So Ken, let me ask you, how has our scale helped us build the MSR business?

Ken Adler:

Well, we spent a lot of time on the financing advantages and David referred to it and I did already. We are the desired partner for the mortgage industry when it comes to MSR investment and it's because of these partnerships we've put together. And what's really noteworthy is when people get this scale, you hear they frequently internalize operations to create efficiency and save costs. What we've found is that scale can create more than those savings through these partnerships. In today's world, there's excess capacity in the mortgage industry both on the origination side and on the servicing side. So when you're negotiating contracts for mortgage services, you are priced out at the marginal costs of those services plus a reasonable profit margin as opposed to the average cost that these entities are paying themselves.

We have no overhead, so we are primarily a variable cost model, but we have a cost structure that's arguably as good and at times better than people that have their own platforms. And again, it's due to the excess capacity as a result of the downturn. The other opportunity that's created through that is when people that own MSR want to sell that MSR, if it's being subserviced or it's owned by somebody who services their own loans, they have a huge preference to sell it to somebody who will retain them as subservicer. So we are seeing opportunities that other people can't take advantage of and those partnerships are very strong. So when people talk about franchise value, the scale has allowed us to create these partnerships that have created real franchise value.

Andreas Strzodka:

Thanks. And Srini, how does scale help the Agency business?

V.S. Srinivasan:

Sure. I mean, as Andreas mentioned, we are the largest mortgage REIT out there and we are probably among the most active in trading specified pools. What this means is that we get a lot more color both on pricing and flows in the market. We are probably involved in the vast majority of flows that happen in the market. This leads to better execution. So when we execute trades, we can get better levels because we have more color. But even away from that, our scale and the nature of our business model gives us multiple points of connectivity with our dealers and financing partners.

We obviously trade Agency MBS with them, which allows them to earn some bid-ask spread, they securitize our non-Agency deals, the OBX shelf, which allows them to earn some fees. They're involved in the lucrative business of financing our warehouse lines for loans and MSR. So when it comes time to ration repo, fortunately financing has been plentiful for the last few years, but there will come a time when repo is being rationed. We feel like we have a much bigger competitive advantage because we have a much deeper relationship with our financial partners.

Ken Adler:

Yeah, look, the synergies are real in both directions. I mean, there's really one team at the firm that manages hedges, prices, models, all interest rate and prepayment exposure. So you're not going to find an MSR business that has access to the sort of portfolio analytics, performance attribution, prepayment modeling that goes on at an Annaly. And that's because of the magnitude of the Agency MBS effort.

Andreas Strzodka:

Thanks you. Thanks Ken. Yeah, that I think gets us to our last topic that we wanted to discuss today, which is the synergies between the business. So for everybody's edification, I sit close to them not only on the stage but also in our office and they frequently talk to each other for whatever reason. So let me ask you guys, what are you guys actually talking about?

V.S. Srinivasan:

So if you think about an Agency MBS book or an MSR book, the unique risk that we take is prepayment risk. And to manage these books well, what you need is a good understanding of prepays, the ability to spot emerging prepayment trends, take all of this information and put it into models, generate cash flows, and come up with good estimates of duration and convexity. So if you can do these five things right, everything else falls in place and we have an excellent team which does our analytics for us, which takes inputs from

all of us and comes up with the analytics that gives us very reasonable duration and convexity on our portfolio. Now to answer your question, Ken and I are nerds, we spend most of our time talking about what we see in our markets and what that means for prepayments. I'll give you an example.

Earlier this year there was considerable debate on how fast newly originated collateral would prepay if mortgage rates rallied to say 6%. On the one hand, the newly originated collateral had very high loan balance, and historically higher loan balance pools tend to respond very aggressively to any rally in rates. On the other hand, they had very high loan to value ratios. What I mean by that is the loan size was typically over 80% or 80% of the home value, and that can sometimes be a constraint to refinance. While we were having this debate on our desk, Ken chimed in and said that services have very attractive bids for current coupon MSR. So my first reaction was if servicers love current coupon MSR, they must not be expecting very fast speeds. Servicers are much closer to borrowers than any bond trader sitting up in New York trading bonds.

And if they thought that speeds are going to be slow because MSR is after all an IO cash flow and faster speeds hurt their valuation. But Ken did his due diligence, he went and talked to our subservicers, he talked to other MSR participants and he came and told us that they're actually expecting really fast speeds. They think they can refinance these borrowers really quickly and they're embedding into the value of MSR the value of the gain on sale on the new loan. So this sort of informed how we positioned ourselves in the Agency MBS book. If you look at our portfolio in higher coupons, particularly Fannie 6s and 6.5s, we were mostly in high quality specified pools.

Basically we paid up for call protection. And lo and behold, when rates did rally to around 6% in September speeds on generic Fannie 6s and 6.5s were much faster than anyone expected. For example, the cheapest Fannie 6.5s paid north of 50 CPR, almost 10 CPR faster than what the market was expecting just two, three months ago. But our portfolio specified pools, which we had paid up for call protection, our Fannie 6s paid at 17 CPR. So this is just one example, but we are constantly talking to each other, trying to understand what the servicer population is thinking about how prepayments are going to evolve. And we take that into account when we construct our Agency MBS portfolio.

Ken Adler:

Yeah. And I just want to add how we use it on the MSR side of synergy. Specified pools are a very granular pricing. You're pricing, the prepayment sensitivity of all sorts of loan attributes, whether it's loan size, geography, who the originator was, FICO, there's several others. MSR is not priced as granularly, it just isn't. And that's because the participants in that market are really not prepayment experts and they're not managing specified pools. So our MSR pricing infrastructure is able to capture those attributes where we believe our peers are absolutely not. And that's allowed us to absolutely construct a portfolio with higher performance qualities than generically and it's just not observed by the market. And that's thanks to the Agency book.

Andreas Strzodka:

Well, thank you very much guys. So unbeknownst to you, I'm getting the red light, which means we're unfortunately out of time. So I hope we were able to demonstrate that our scale and our flexibility helps us to try to achieve the most attractive relative and absolute returns and that we're doing all of this in a collaborative fashion. I'm now happy to announce Mike Fania, our Deputy Chief Investment Officer and Head of Residential Credit. He will give you an overview of the Onslow Bay conduit. With that, thank you very much for your attention. Over to you, Mike.