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Is Annaly Capital Management a Buy?

The agency mortgage REIT may have some tailwinds.



 **Dave Kovalski** (TMFdkovalski)

 Mar 23, 2020 at 9:35AM

The current bear market has hit hard, but for savvy investors, it has brought prices and valuations down to create some great buying opportunities. The question investors should be asking themselves is, Which stocks are great buys right now?

Let's take a look at **Annaly Capital Management** ([NYSE:NLY](#)), a New York City-based mortgage real estate investment trust (REIT). Is Annaly Capital a buy?

REITs are down big

Like the rest of the market, [REITs](#) have been pounded this year. The **FTSE Nareit All REITs Index**, which tracks all REITs, dropped 17.8% on Monday alone -- the worst day for the stock market since 1987. A major catalyst was the Federal Reserve's decision on March 15 to lower interest rates to the 0%-to-0.25% range. Year to date, the **FTSE Nareit Mortgage REIT Index** is down 42.3%. Home financing REITs are down 39.6%, while commercial financing REITs are down 48.1%.

Annaly Capital, a mortgage REIT, is currently down 43.6% year to date. Annaly invests primarily in agency mortgage-backed securities (MBS), mortgages issued by federal agencies like **Fannie Mae** and **Freddie Mac**. Agency mortgage REITs typically generate lower yields than nonagency mortgage REITs, but they are less risky.



IMAGE SOURCE: GETTY IMAGES.

"Annaly is invested primarily in agency mortgage-backed securities (MBS), which are insured against default by the federal government and guarantee the timely payment of interest and principal," said Calvin Schnure, senior vice president of research and economic analysis at the National Association of Real Estate Investment Trusts. "They have very little credit exposure or risk of delinquencies or defaults." Specifically, Annaly had about 88% of its assets in agency-backed mortgage securities at the end of 2019.

In general, agency REITs have experienced a drop in share price in this sell-off that is out of line with their low credit risk exposure, Schnure said. However, the [Fed's decision](#) on March 15 to buy \$200 billion of agency MBS will help REITs like Annaly. "The Fed's commitment to buy \$200 billion of agency securities provides liquidity and that prevents a fire sale," said Schnure. "That means they're pretty well protected by a Fed backstop right now."

Looking back to the 2008-09 market crash, agency mortgage REITs were the only major sector that invests in MBS to weather the crisis without government support, said Schnure. "That tells you something," he said.

During the crisis, Annaly posted returns of 30.7% in 2007, -12.7% in 2008, 9.3% in 2009, and 3.3% in 2010.

An attractive time for the business model

The company held a call on March 16 to update investors and analysts on its status and to introduce new CEO David Finkelstein. He has been with the company since 2013 and since 2016 has been CIO, a position he maintains after taking on the new leadership role.

Elevated volatility and prepayment concerns have had an impact on agency REITs, said Finkelstein on the call. When rates drop so low and so sharply, many consumers refinance or prepay their mortgages, which eliminates future interest payments. The REIT modestly reduced its agency positions in January and February and gravitated further down in coupon to offset prepayments, Finkelstein said. In its commercial mortgages, it employs rigid underwriting standards and focuses on defensive industries. It is underweight in retail and hotels and has no direct exposure to energy or travel-related sectors.

But to echo Schnure, Finkelstein added that the liquidity offered to the market by the Fed should "provide a meaningful tailwind to our business. With respect to agency MBS, this is arguably the cheapest the sector has been since the onset." The added liquidity should tighten the spreads between MBS and Treasury yields, which have widened. Also, Finkelstein said a prolonged period with 0% interest rates should be highly supportive of financing markets. "As the dust settles, we expect this to be an incredibly attractive time for our business model," Finkelstein said on the call.

Is Annaly a buy?

Also, on March 16, the company announced plans to keep its quarterly dividend at \$0.25 per share. It has a dividend yield of 17.4%, which is higher than the average REIT. The high dividend, along with the extremely low price and the recent Fed actions, should cause the [REIT](#) to begin to reverse its decline. Times are so uncertain, it is hard to recommend a buy right now, but keep an eye on trends in agency MBS and consider this REIT a good option if the market starts turning.

Dave Kovaleski has no position in any of the stocks mentioned. The Motley Fool has no position in any of the stocks mentioned. The Motley Fool has a disclosure policy.

Is Annaly Capital Management a Buy?

Don't let Annaly's 11% yield fool you -- there's a lot more risk here than investors may realize.



 **Reuben Gregg Brewer** (TMFReubenGBrewer)

 Sep 28, 2019 at 9:01AM

 [Author Bio](#)

Annaly Capital Management ([NYSE:NLY](#)) is a [real estate investment trust](#) (REIT), a corporate structure intended to throw off a steady stream of income to shareholders. Add in the massive 11% yield the stock is offering today, and investors with an income focus might be tempted to dive in and start collecting a big quarterly dividend check. Don't do it until you fully understand these three risks.

1. A different kind of REIT

All REITs are not created equal. That's a big issue here because Annaly's focus is on owning mortgages, not physical property. While mortgages do have value, most investors likely think of buildings when they conjure up an image of a REIT. It is an important difference. If a tenant goes belly-up, a REIT with a building can simply find a new renter. From a bigger-picture perspective, if the financial system starts to go haywire (like it did during the deep 2007-2009 recession), there are actual physical assets underpinning the rent roll.



IMAGE SOURCE: GETTY IMAGES.

A mortgage REIT, on the other hand, buys and sells pieces of paper. Generally that means collections of mortgages put into a mortgage bond. The company earns the difference between its cost of capital (the debt and equity it sells) and the interest rate on the mortgage securities it owns. While there are technically physical assets behind the mortgages involved, getting an individual property vacated and sold to salvage some value is not an easy task. And, if the financial markets go into a tailspin, the value of the mortgage securities in the portfolio could plummet and/or the bonds could become illiquid. That would leave Annaly and its shareholders stuck waiting for better days or, if things got really bad, it could be forced to sell assets at fire-sale prices.

These are worst-case scenarios, of course, but [the Great Recession](#) proves that they sometimes come to pass. And that downturn included the bankruptcy of a few once-sizable mortgage REITs.

2. Interest rates

Interest rates have an impact on the entire real estate sector. For example, low rates make raising capital cheap for property buyers using debt. [Some](#)

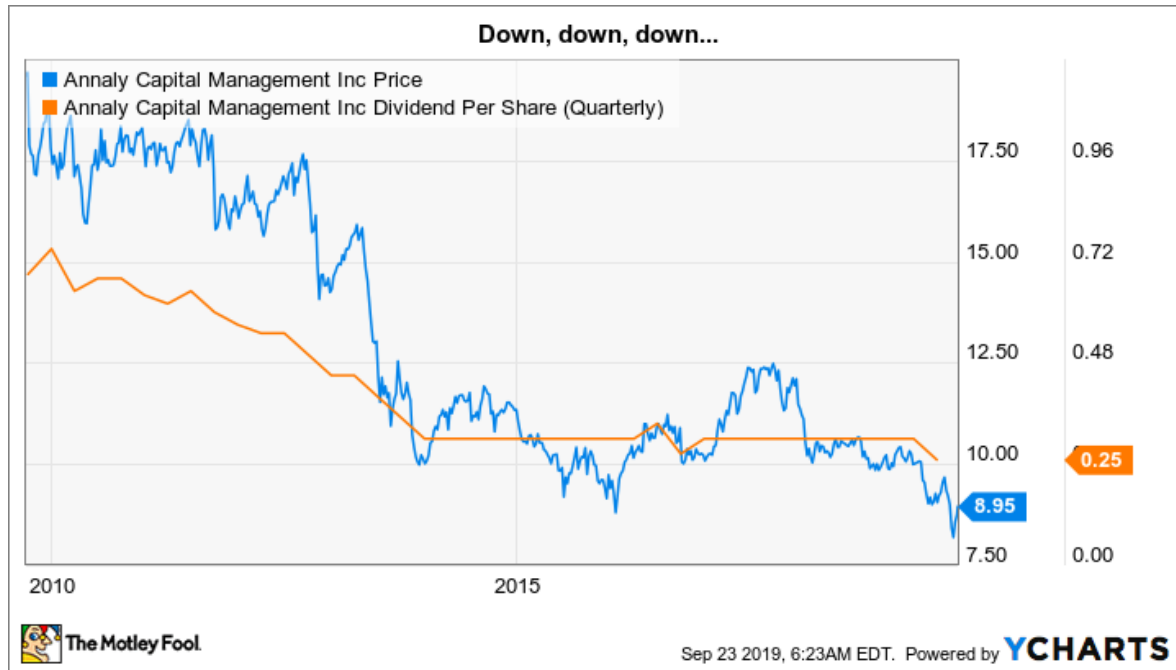
[REITs are taking advantage of this situation today and going on buying sprees](#). High rates, on the other hand, make it more expensive to raise money. That said, if a REIT buys a building and locks in long-term funding via a bond or equity sale, changes in interest rates aren't a major problem. The economics of that property are pretty much set. That's a simplification of a very complex issue, but it highlights an important point. The value of mortgage bonds, like all bonds, generally goes up and down as interest rates change, so the core value of Annaly's portfolio is highly variable. And, thus, its stock price will be highly sensitive to interest rate changes as well.

The extra volatility that can add is bad enough. But there's another problem when you deal with mortgages. People often refinance their loans when rates change. That's not usually a big issue when rates are rising, but when rates are falling, like they have in recent years, repayments can materially alter the economics of a bond. In other words, what once seemed like a great security can turn into a middling one if too many mortgages get paid off early. That's not to suggest that the desirability of a physical property can't change over time, but there's an inherent difference in the process and remedy. You can spruce up a building; there's little you can do with a mortgage bond that's not living up to expectations.

3. Some charts to pull it all together

Points one and two are high level. [Investors looking to own reliable dividend-paying stocks](#) just need to understand that Annaly is very different from a property-owning REIT. And, for most people, there are simply better options out there. That's particularly true for those with a conservative bent.

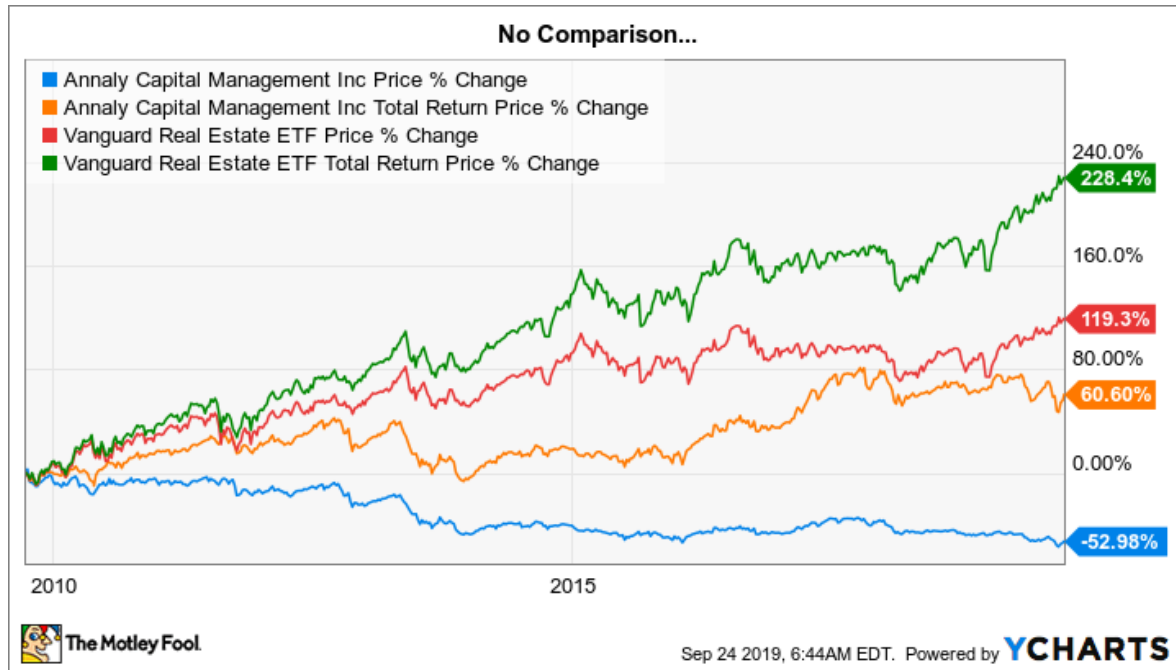
But often a picture can tell a story better than words alone. And that's painfully true here. The graph below charts Annaly's dividend and share price over the past 10 years. Notice the steady decline in both. The inherent problems with the mortgage bond focus noted above have clearly had an impact on investors.



[NLY](#) DATA BY [YCHARTS](#).

What's interesting about this is that Annaly's [dividend yield](#) has stayed in the 10%-plus space throughout the last decade. In other words, the REIT's fat yield has looked attractive for a long time even though this investment hasn't been particularly good for shareholders. The logic is simple: As the dividend gets cut, the stock price falls. That keeps the yield high, but shareholders get a double whammy: Less income from an asset that isn't worth as much as it once was.

Even reinvesting the dividends doesn't do enough to salvage Annaly. Yes, buying more shares with the dividend pulls the [total return](#) up to around 55% over the past decade, but it still falls well short of other options. For example, the total return for **Vanguard Real Estate ETF** was 215% over the same span. There's really no comparison.



[NLY](#) DATA BY [YCHARTS](#).

Not worth it

For most income investors, the risks involved with Annaly just aren't worth it. There is just too much risk and the company's history shows that the downside is considerable. Yes, this REIT has a huge yield. But that's not enough to make it a good investment.

Reuben Gregg Brewer has no position in any of the stocks mentioned. The Motley Fool owns shares of Vanguard REIT ETF. The Motley Fool has a [disclosure policy](#).

Annaly Capital Management Inc (NLY) Q1 2019 Earnings Call Transcript

NLY earnings call for the period ending March 31, 2019.



 **Motley Fool Transcribers** (MFTranscribers)

 May 2, 2019 at 9:25PM

Annaly Capital Management Inc ([NYSE:NLY](#))

Q1 2019 Earnings Call

May. 02, 2019, 9:00 a.m. ET

Contents:

- Prepared Remarks
- Questions and Answers
- Call Participants



Prepared Remarks:

Operator

Good morning and welcome to the Annaly Capital Management Quarterly Conference Call. All participants will be in listen-only mode. (Operator Instructions)

I would now like to turn the conference over to Jillian Detmer, Head of Investor Relations and Marketing. Please go ahead.

Jillian Detmer -- *Head of Investor Relations and Marketing*

Good morning and welcome to the First Quarter 2019 Earnings Call for Annaly Capital Management Inc. Any forward-looking statements made during today's call are subject to risks and uncertainties which are outlined in the Risk Factors section in our most recent annual and quarterly SEC filings.

Actual events and results may differ materially from these forward-looking statements. We encourage you to read the forward-looking statements disclaimer in our earnings release in addition to our quarterly and annual filings. Additionally the content of this conference call may contain time-sensitive information that is accurate only as of the date of the earnings call.

We do not undertake and specifically disclaim any obligation to update or revise this information.

During this call we may present both GAAP and non-GAAP financial measures. A reconciliation of GAAP to non-GAAP measures is included in our earnings release. As a reminder, Annaly routinely posts important information for investors on the company's website www.annaly.com. Content referenced in today's call can be found in our first quarter 2019 investor presentation and first quarter 2019 financial supplement both found under the Presentation section of our website.

Annaly intends to use of our web page as a means of disclosing material nonpublic information for complying with the company's disclosure obligations under Regulation FD and to post and update investor presentations and similar materials on a regular basis. Annaly encourages investors, analysts the media and others interested in Annaly to monitor the company's website in addition to following Annaly's press releases, SEC filings, public conference calls, presentations, webcasts and other information it posts from time to time on its website. Please also note this event is being recorded.

Participants on this morning's call include: Kevin Keyes, Chairman, Chief Executive Officer and President; David Finkelstein, Chief Investment Officer; Glenn Votek, Chief Financial Officer; Mike Fania, Annaly Head of Residential Credit Group; Timothy Gallagher, Annaly Head of Commercial Real Estate Group; and Tim Coffey Chief Credit Officer.

I'll now turn the conference over to Kevin Keyes.

Kevin Keyes -- *Chairman, Chief Executive officer and President*

Thank you, Jillian. Good morning everyone and welcome to the call. Today we see the return of flashing red lights across markets. The environment is characterized by a flattening curve, the hunt for yield has compressed credit spreads with little differentiation of risk.

Hypnotizing low volatility has resurfaced and trended 70% lower than the Christmas Eve high. The correlation between the S&P 500 and Treasury market has risen over 20% in the past two months. The last time across

asset correlations increased this much was in advance of the spike and volatility and the Southern market correction that followed in the fourth quarter of last year.

And IPO volume, always a leading indicator of a high-priced equity market already stands at approximately \$30 billion for the year, a dangerously high level not seen since 2007.

Within this challenging marketplace, there are three significant and expanding macro realities which substantiate Annaly's important position in any market environment: GSE mandatory shrinkage and potential reform, the Fed's exit from MBS purchases and banks reducing their footprint in the mortgage market.

Going forward and over the long-term, Annaly's model, size, diversity and scalability provide the market a permanent capital solution for the REIT distribution of these assets and provide our shareholders a unique opportunity to participate in the growth of our relevance, not only in the mortgage markets, but also in the financial sector and the economy overall.

So first, GSE mandatory shrinkage and potential reform. Over the more notable developments since our last call was the appointment of Mark Calabria as the Director of the Federal Housing Finance Agency. In his first interview in his role, he has stressed a renewed focus to return Fannie and Freddie to private hands. While GSE reform remains highly topical, the reality is, we have already been experiencing reform without legislation. Most notably in the form of the credit risk sharing transactions.

Since its inception in 2013, the CRT market has grown considerably with cumulative issuance in excess of \$70 billion, transferring a significant portion of credit risk on \$2.8 trillion of unpaid principal balance. In anticipation of the growth of this market which has fueled the revitalization of new issuance in private label's residential credit, Annaly positioned itself to capitalize on the future of housing finance, opportunistically investing in CRT, as well as loans to borrowers currently underserved by the bank channel.

Since 2015 we have expanded our origination joint ventures and platform, growing our portfolio to approximately \$3.5 billion today. As GSE shrinkage continues, taking shape in the coming months and years, dedicated private capital will be necessary to absorb increased supply from the GSEs to the U.S. housing market to continue to function efficiently. Second, I've also stated that the Fed exiting the mortgage market is a huge opportunity for Annaly and the private market overall.

Permanent capital is needed as a solution for the REIT distribution of these assets as well. Since the Fed began tapering reinvestments in October of 2017, \$200 billion of mortgage assets have shifted back to the private markets. Over this time, Annaly has added about \$30 billion of assets, which equates to roughly 15% of the total runoff. While the Fed's actions are influencing markets across sectors, Annaly has demonstrated its relevance as a long-term owner of these assets, while providing our own influence in leadership and helping to shape the future of housing finance in the U.S.

We are a leading voice on the FHFA's implementation of a new common security called the Uniform Mortgage-Backed Security or UMBS through our active participation on SIFMA's Advisory Council. We have co-authored the industry's thought leadership paper with the New York Fed on the CRT market and have a dedicated government relations effort in Washington D.C. focused on providing market insight and structuring advice to policymakers.

The third long-term opportunity for Annaly is the result of banks shrinking their mortgage businesses. Back in 2016, I stated on an earnings call that the impact of regulation was more obvious than ever and all four of our businesses were designed to fill the emerging voids in investment and financing markets caused by the evolving regulatory playbook. Although banks remain the single largest holder of U.S. mortgage debt, their mortgage-related exposure has trended lower as a result of the regulatory regime. And non-banks have stepped in accordingly.

The top 15 bank mortgage originators have seen their market share reduce by 30% since 2012 as other originators have increased volume. Since the beginning of 2014 non-banks share of total agency mortgage origination is up from 29% to 53% of the market. This ongoing shift was recently

reinforced in first quarter earnings commentary from bank executives, highlighting the retreated mortgage origination and servicing exposure.

Wells Fargo management recognized that non-bank competitors have set the bar and will remain active participants on both the origination and servicing side. JPMorgan management further acknowledged by stating "Not all non-banks are situated similarly, there's some healthy thriving well capitalized and responsibly run companies and there are some others who may not be standing at the end of another downturn." We couldn't agree more that all non-banks are not -- are created equal, just like we've stressed for the mortgage REIT industry for the past number of years.

This is where Annaly uniquely fits in as an established large liquid capital and financing partner, within the mortgage supply chain. While nearly all other companies within the financial sector and even most of Corporate America require the heavy investment in the design, manufacturing, sales and servicing of products to grow and gain market share Annaly doesn't have to invest to create supply, rather over the past five years, we have already built a home for the redistribution and ownership of this increasing supply from the GSEs, the Fed and the banks with our \$16 billion capital base, our liquidity and our diversified structure.

We have in-house expertise to underwrite the credit manufactured by these other entities. Our proprietary partnerships with originators provide us a unique role, granting us access to the product and the market knowledge that comes with it, without paying for the underlying infrastructure. And our differentiated ability to finance the assets we own, sets us apart as a partner and as an independent operator.

Regarding financing as I discussed on our last quarterly earnings call, our financing expertise and focus on capital optimization is a major competitive theme this year. We have continued to expand beyond traditional financing for the credit businesses and for the agency businesses as part of our 10 distinct financing alternatives. We have demonstrated our capital markets leadership through alternative methods of execution such as the securitization in CLO markets.

Specifically we have completed five residential securitizations for aggregate proceeds of roughly \$2 billion since the beginning of 2018, including two this year, establishing Annaly as the fourth largest non-bank issuer in the residential sector over the last year. Our \$850 million commercial real estate CLO executed in the first quarter, is the largest in the market this year and the sixth largest post-crisis. These transactions effectively increase our leverage returns by over 75 basis points and provide additional liquidity for more efficient reinvestments over the long-term. With these financings, a new set of investors are clearly endorsing our investments and strategy, credit discipline and underwriting capabilities.

With respect to financing efforts for the agency portfolio, we have secured what no other company in the industry can claim. We have limited our exposure with our own broker-dealer to less than quarter of our total repo balance and uniquely diversify the counterparties that the entity faces with 40% direct repo to over a dozen sizable proprietary financing partners such as sovereign wealth funds and pension funds.

And then another step to increase our capital efficiency, we announced the redemption of the preferred equity acquired as part of the MTGE acquisition. With this redemption, we retired capital 25% more expensive than our most recent preferred issue in 2018 illustrating our ability through consolidation to clean up a formally inefficient capital structure capturing savings for all shareholders.

Also this past quarter, we published a comprehensive narrative around our extensive corporate responsibility commitment, further augmented by our annual report and proxy statement. As investors have sharpened their focus on ESG, we have enhanced our disclosure to underscore the way we have long managed the business and further defined metrics we feel are important to our shareholders.

As outlined in our quarterly investor presentation, recent research has validated that greater representation of women onboard is linked to stronger company performance. More distinctly, having more women in senior leadership roles and agenda diverse workforce as we have at Annaly, more broadly boost profitability enhances risk management and contributes to

lower price and earnings volatility. Our attention to ESG is a differentiator among our peers and the entire market and is validated by our sustained performance.

Since 2014, Annaly's quarterly total shareholder returns exhibit the lowest volatility in the agency sector by far and we have produced core earnings per share 90% more stable than the industry average. This quarter we produced an ESG disclosure scorecard in our investor presentation benchmarking relevant metrics against our peers. Metrics that we believe need to be disclosed by every single public company.

We continue to embrace lean corporate governance practices across all aspects of our business and constantly focused on alignment with shareholders. As further evidence of this commitment, this past quarter we proactively reduced the management fee on incremental capital we raised by almost 30%. This is the ultimate act of governance and clearly demonstrates the benefits of our scale and operational efficiency we have achieved as our company continues to grow.

Since the fourth quarter of 2013, we've delivered unmatched stability with our dividend the product of our diversification strategy in operating efficiencies. For 22 consecutive quarters, we distributed the same dividend. While in 19 of those 22 quarters the 2s, 10s curve flattened, the type of streak never seen before in the market.

Also during this time, Annaly's dividend yield on book value has risen nearly 250 basis points while the 2s, 10s spread has contracted by the same magnitude. We have remained transparent about real returns achievable in today's market using prudent leverage. A primary focus of our last earnings call highlighted that current returns were not as lofty as other suggested or were achievable only due to short-term market dynamics we didn't assume would ever persist such as favorable dislocations in the LIBOR-OIS relationship.

Accordingly, we have pre-announced an expected quarterly dividend \$0.25 for the second quarter and for the remainder of 2019. This translates to a yield in line with our historical payout ratio over the past five years and is more reflective of our less levered diversified business mix. Although, we

could maintain elevated earnings and dividend payouts by increasing leverage, we are focused on optimal liquidity thresholds in managing the portfolio within conservative risk parameters to produce the highest level of quality earnings in this market environment.

Annaly's strong record will -- strong track record will continue. We will continue to deliver sustainable income to our shareholders through our diversified cyclical and countercyclical businesses. Our high-margin, low-beta cash flow engine is built to endure any market. We are positioned for the long-term as an influential market leader in the future of real estate finance and business lending across the country.

With that, I'll turn the call over to David to discuss our investment activity and outlook.

David Finkelstein -- *Chief Investment Officer*

Thank you, Kevin. The Federal Reserve's meaningful policy shift drove financial markets in the first -- interest rates lower implied volatilities, spread tightening across fixed income sectors. Agency MBS retraced a portion of the spread widening the plagued the sector in the fourth quarter -- and other risk sectors. We added \$14 billion in assets the vast majority of which allocated to the agency sector increasing our equity capital allocation agency to 76%. We generated a 6.2% economic return over the quarter with leverage in line with year-end at seven turns.

Turning to portfolio activity and beginning with the agency business, our asset additions included both pools as well as TBAs, the majority of which were purchased coincident with our equity raise in January and levered returns in excess of 100 basis points above current levels. Higher-quality specified pools significantly outperform more generic collateral, given the renewed demand for call protection in light of lower rates.

Investor preference for pools has also been motivated by concerns of a more negatively convex TBA deliverable as the Fed further unwinds its portfolio and originators continue to deliver higher loan rate loans into relatively lower coupon securities. While these concerns are certainly valid

they appear to be now priced into the TBA market and thus we anticipate maintaining our holdings of TBAs over the new term.

Further widening between pool and TBA pricing may suggest that expectations of the cheapest to deliver cohort are overly pessimistic in which case the option to take delivery of TBAs maybe a viable strategy.

On the hedging side, the decrease in our hedge ratio is largely attributable to runoff of shorter date swaps. We opted to maintain this lower hedge ratio as the decline in interest rates reduced MBS durations and consequently our rate exposure remains well contained and consistent with that of year-end in spite of the swap runoff.

Shifting to our credit businesses, in our residential strategy as Kevin noted, we have completed two securitizations thus far in the year and continue to reduce our reliance on FHLB financing for whole loans. The first transaction in January -- agency eligible investor loans, where the market has demonstrated a greater appetite for credit exposure to these borrowers, the GSEs through more advantageous pricing.

Our second transaction in April consisted a non-QM -- sorry consisted of non-QM collateral characterized by high-credit quality, expanded prime borrowers with minimal mitigating factors, but the non-QM classification has led the traditional bank origination model to neglect these borrowers. Both transactions generated low double-digit returns on retained bonds with minimal repo leverage, a return nearly impossible to achieve through purchasing assets in the secondary market at today's spreads.

New origination whole loans remain cheap to securities and we closed nearly \$400 million loans in the first quarter. We continue to expand our loan acquisition channels and we expect to remain a programmatic issuer to our Onslow Bay subsidiary.

In our commercial business, while asset additions did exceed runoff our CLO execution led to a roughly 20% decline in the economic interest of the portfolio. As Kevin discussed, the terms of the transaction compared favorably to warehouse line financing as the roughly 80% advance rate sold

at a weighted average spread of 163 basis points increased the yield on retained assets by over 75 basis points.

Further, the non-recourse nature of the CLO structure improves -- profile of our portfolio. We do remain cautious on the commercial sector given both underlying asset prices. We expect to maintain our allocation of the sector and the ability to replace CLO runoff back into the vehicle that are pre-locked-in economics will help achieve without sacrificing returns or credit quality.

Our Middle Market Lending business shrank modestly this past quarter. However, similar to CRE, this is a function of the successful distribution of assets notably the completion of the syndication of a \$440 million loan priced in the fourth quarter and subsequent disposition of \$177 million of that loan in the first quarter.

Looking forward, we do not expect to see the nearly 50% annual asset growth in our MML business that we have achieved over the past three years as the number of our opportunities with countercyclical profiles with appropriate sponsors has not kept pace with historical averages. We do remain a reliable partner to private equity with the ability to provide considerable liquidity to the Middle Market sector and our ability to be selective in credit and hold larger positions is a significant differentiating factor that we will continue to utilize.

Now as we look forward, we intend to preserve a higher allocation to agency given better fundamentals and a favorable valuation relative to credit over the near-term. However, we remain active across our credit businesses. We expect to maintain our exposure through healthy pipelines, which should offset upcoming payoffs given the pristine quality of our assets. This allows us to hold a considerable option to move quickly should we see what we believe to be a transitory dislocation similar to this past December.

In the meantime, our leverage may increase modestly as a result of higher agency allocation, but it is certainly not our intention to increase leverage in attempt to fight the reality of tight asset spreads in a persistently flat yield curve. We will continue to navigate the current market environment in a prudent fashion across our businesses resulting in a lower levered and more

diversified and higher credit quality -- higher-quality return for our shareholders.

Now with that, I will hand it over to Glenn to discuss the financials.

Glenn Votek -- *Chief Financial Officer*

Thank you, David. While our earnings release discloses both GAAP and non-GAAP financial results, I'll be focusing this morning primarily on our non-GAAP core results and related metrics all excluding PAA. Additionally, a number of the themes for the year that Kevin has discussed were quite evident in the quarter, notably capital optimization and technology and I'll briefly touch on certain aspects of each of those.

So, beginning with the financial results for the quarter, we generated core earnings of \$433 million or \$0.29 a share which compares to \$417 million also \$0.29 a share in Q4. We reported a GAAP loss of \$0.63 versus the prior quarter GAAP loss of \$1.74.

Among the factors impacting the GAAP results were losses on the hedge portfolio and investment sales both of which improved from the prior quarter. Comprehensive income which includes fair value changes in our agency portfolio running through equity was \$811 million or \$0.56 per share and resulted in a 3% increase in book value.

Interest income was up modestly in the quarter, but was largely offset by a decline in dollar roll income and interest expense increase driven by both higher rates and balances with our average repo rate for the quarterly increasing roughly 21 basis points.

The higher interest cost was fully offset by the interest component of our swaps portfolio which remains in a net receipt position and resulted in our overall cost of funds declining modestly.

However, we expect this benefit to diminish given current LIBOR and repo funding rates and maturing swaps that have contributed to net receipt position, so while our net interest margin was 151 basis points for the quarter, these factors coupled with a persistently flat yield curve will exert pressure on our net interest margins going forward.

During the quarter, we generated attractive returns using conservative leverage levels as core ROE improved slightly to 11.6% and our core ROE per unit of leverage was 166 basis points also slightly improved from Q4 as economic leverage was unchanged at seven times as David had previously noted.

Portfolio assets grew \$14 billion led by agency investments which is largely where the capital raise early in the quarter was deployed and the CLO and securitization that Kevin mentioned created movement among the balance sheet accounts during the quarter that's worth highlighting.

The transactions resulted in \$1.1 billion in assets moving within the balance sheet from loans its assets transferred or pledged to securitization vehicles and that contributed to the loans balance on our balance sheet declining \$707 million and conversely, assets transferred or pledged to securitization vehicles increasing by \$532 million. Our actual loan purchases and originations in the quarter were approximately \$715 million and total credit assets sourced during the quarter were over \$1 billion.

And lastly an aspect of our business that we've routinely highlighted as constantly borne up our financial results is the efficiency and scale of our operating platform. Our efficiency metrics which improved in the quarter continue to be best-in-class and our technology investments continue to allow us to exceed in this area.

We've invested significantly in technology since beginning of 2016 adding talent to drive our long-term IT strategy to create state-of-the-art systems as they continue to diversify into new product areas and leverage the investment expertise across our business.

We spent over \$50 million on technology over this timeframe on a multiphase IT plan. You may have noticed that we filed a press release along with our earnings announcement yesterday regarding execution of one element of the plan now that being master data management or MDM which focuses on the effective delivery and leveraging of data across the firm.

We live in a moment where technology can redefine processes to drive efficiencies and enhanced data analytics to support business investment

decisions. We're embracing these technologies and we're already seeing the benefits that will become even more strategically important as our partnerships expand and our business growth continues.

And so with that, Debbie, we will open it up for questions.

Questions and Answers:

Operator

We will now begin the question-and-answer session. (Operator Instructions)
The first question comes from Bose George with KBW. Please go ahead.

Bose George -- KBW -- Analyst

Hey good morning. Actually I wanted to ask about returns in the agency market it sounds like that's where you see the best opportunities, but can you talk a little bit more specifically about spreads and what kind of leverage are you targeting for the agency business?

David Finkelstein -- Chief Investment Officer

Sure. Hi, Bose. This is David. In terms of returns the current yield on agency MBS is around 330 with funding costs in the low 260s and you get a hedge benefit of about 20 to 25 basis points. And that leads to at eight turns of leverage a little over 10.5% levered nine turns is a little bit over 11.5%.

The way we look at agency leverage we do have a bar-belled approach we're very under-levered in the credit businesses, the average is about one turn and we do use the agency portfolio to help fund the portion of those assets. So, agency leverage is somewhat artificially higher to about nine turns currently. Does that answer your question?

Bose George -- KBW -- Analyst

Yes. Yes, that's helpful. Thanks. And then just wanted to get your thoughts on agency spreads and in the scenario where rates rally or potentially go the other way just how do you think spreads are set up for the year?

David Finkelstein -- Chief Investment Officer

Sure. So, we did experienced a bit of a rally in late March which did sort of questioned the callability of agency MBS there were some fears that refis would pick up when we got into the 230s on the 10-year note. And so Agency MBS did underperform.

To the extent that the market does rally back and it's in a parallel fashion without being influenced by a rate cut by the Fed or rate cuts by the Fed and the curve doesn't steepen, then you would expect agency to underperform in that environment because of prepayes. And to the extent we sell off modestly, agency should do just fine, because we get away from sort of that callability of the sector.

Bose George -- *KBW -- Analyst*

Okay, great. Thanks.

David Finkelstein -- *Chief Investment Officer*

You bet.

Operator

The next question comes from Mark DeVries with Barclays. Please go ahead.

Mark DeVries -- *Barclays -- Analyst*

Yeah. Thanks. So I heard your comments about flattening yield curve and compressing spreads and also expecting kind of additional pressure on NIM going forward. But when I look at, kind of, the returns available that you described in your different strategies, it didn't seem like it moved that much from last quarter. So I'm wondering if you can give me a better sense of kind of what's changed on your outlook for earnings power here that led to the dividend cut.

Kevin Keyes -- *Chairman, Chief Executive officer and President*

Hey, Mark. Well, what's changed, I mean, I think -- look, the way we approached this quarter is not just this quarter, it's really for the foreseeable future. And my commentary around the last five years and the stability that we've -- that we demonstrated was we were the only company who didn't

cut dividends for over five years. In fact, there were multiple cuts 60 over 60 dividend cuts in the mortgage REIT sector, 29 dividend cuts in the agency sector and the average cut was about 30% over time. And in the agency sector the average cut was about 44%.

So we put that into context to the past and now we're here with the future outlook. We want to manage this company, again, for the next five years at a level of, not just leverage or positioning for any one business, but overall for this entire business. How we think capital allocation should unfold and what our goals are. And our goals are to basically continue the diversification strategy and become a less levered longer-term cash flow company.

So in saying all that, this quarter's reduction was really a function of frankly things we can't control in the marketplace. And I started my commentary with some of that. So my -- the one qualification I would make is, I think, this market, we are in the threshold of a lot more risk in all asset classes than the peers. This is entirely a momentum market and it's not a fundamentally driven market.

So by definition, we could continue the dividend. We could maintain or be close to it by increasing leverage, but in this world with so much leverage already in the system, with the latency out there and the correlations, as I mentioned, pointing to a lot more volatility down the road and that maybe not next quarter or the quarter after that, but over the longer term, we just want to be comfortable in managing this business and be in a opportunistic liquidity position to pick our spots.

And frankly, I think, we have a totally different disposition than most others that only have one strategy. When you only have one strategy in a market where the curves flattened and you only have leverage to play with in terms of an earnings lever. That is just a different risk paradigm.

So, for us, this quarter we wanted to preannounce -- have an ability to describe what we were doing, not just do it at the time of the dividend announcement which would have been in mid-June. We wanted to offer and have a dialogue about what we're doing. But long story short, we see a lot more risks in this market today than we have in the past couple of years, as it relates to generating that similar return.

We could do it, but it's more risky. So we're choosing to deliver a return that's still at a premium to most other asset classes, giving everything else is contracted, especially in the yield world. And we're just going to do it more conservatively and we don't expect to have to go down the steps of value, like most other mortgage REITs have been forced to do, with multiple dividend cuts some of them 5, 6, 10 times over the last few years, because they haven't managed the risk like we believe we should manage the way we want to manage it.

David can be more specific on the return environment, but things may have not contracted that much in the headlines. But when you go into the risk profile of some of the credit that we're seeing and not doing, there's different pockets of risk that are emerging for a lot of different reasons.

David Finkelstein -- *Chief Investment Officer*

Yes. Mark, I'll just add. We did talk a lot about the return environment last quarter, as Kevin noted, and returns have obviously compressed, but one of the areas of focus in terms of understanding why it is on the liability side of the balance sheet, you've obviously heard a lot this quarter about the compression in LIBOR versus financing rates, which have probably declined from 282 LIBOR peak to 257 this morning.

So 25 basis point decline in LIBOR, which impacts our receive rate on our swaps, but also we did have swaps that were, with pay rates, set at lower rate environment which have runoff and so that also hurts the returns somewhat. And so going forward, we're comfortable with the return profile but it's -- in this curve environment, in this spread environment it's just not what it has been in the past.

Mark DeVries -- *Barclays -- Analyst*

Okay. That's very helpful. Thank you.

Okay. That's very helpful. Thank you.

Operator

The next question comes from Doug Harter with Credit Suisse. Please go ahead.

Douglas Harter -- *Credit Suisse -- Analyst*

Thanks. Given your commentary about the attractive -- the potential volatility out there and wanting to be cautious, what are your thoughts about leverage levels and any expectations that you might take down leverage during the periods that come?

David Finkelstein -- *Chief Investment Officer*

Sure, Doug. This is David. And as I said in my prepared comments, the higher allocation to agency does allow us to increase leverage. We are relatively low levered. We're 76% allocated to agency, it's seven turns. We do have a little bit of room to move that higher.

In terms of volatility, it's certainly something where you're concerned about. We have recently added to our swaps position and we'll manage that volatility. But in terms of rate volatility we're not as concerned about rate volatility as we are the potential for credit volatility. I think yesterday's discussion by Pau (ph) was relatively balanced. We do feel like the bar to cut interest rates is relatively high given what he said about inflation being transient et cetera.

And also yield do somewhat have a ceiling given low inflation expectations as well as the global yield landscape. So rate volatility we're not as concerned about, which is supportive of Agency MBS, but credit volatility could pick up. And Kevin will add.

What I will just add to that there is the macro picture here Doug is -- there's a supply demand imbalance on Agency MBS is an opportunity for us. I mean, there's -- the estimate for the issuers is about \$430 billion of Agency MBS to come to market. About \$80 billion of that has been out and there's \$350 billion to come.

So there is opportunity there for us on a risk adjusted basis assuming spreads aren't -- it's more likely they are going to lighten up here than contract with all supply not to mention the \$1.2 trillion of treasuries yet to come out of the \$1.6 billion -- trillion on the budget. So there is that opportunity in the agency market, which is foreseeable and it's liquid.

To David's points on credit, I think we've been pretty consistent over the past couple of years to say we're picking our spots episodically and we're going to do probably bigger deals in credit, not necessarily industry focused but just go deeper in the credit and write bigger checks, which typically those types of financings are a lot less competitive, so we can maintain the returns with a lot less leverage on our competition because we can write the big check and that complements our -- the agency strategy, which will benefit from the supply to come, we believe relative to the returns of where we are today.

Great. Thank you, guys.

Operator

The next question is from Matthew Howlett with Nomura. Please go ahead.

Matthew Howlett -- *Nomura Instinet -- Analyst*

Thanks. And Kevin just to follow-up on the credit, I mean long-term you've always said that you want to see a much bigger allocation to that I know you're picking your spots. What do you need to see the spreads widen out and relative to agencies to start picking up that exposure it sounds like it's got to go down a little bit in the near term? Or do we need to see the cycle play out or just better quality deals happen just sort of what's the long-term -- how should we think about the long-term picture on exposure to that market?

David Finkelstein -- *Chief Investment Officer*

Hi, Matt this is David. I think all of the above. The spread widening we saw in December was encouraging and we certainly added in securitized form. We do still see quality deals in our lending businesses. And when they're priced appropriately and lending spreads have not contracted as much as security spreads certainly. But there's a lot of competition for those assets, but nonetheless we are aggressive and we would like to see some loosening.

In terms of the resi business that does happen to be one area where we're certainly confident where and we're at in housing as well as where spreads

are. Housing's probably better situated than some of the other credit sectors just given the technicals in favor of housing.

In loan spreads, while security spreads have certainly contracted this year, loan spreads have remained relatively stable. So we're picking our spots, we can add assets in all of the businesses but runoff is also pretty robust and so we're hopeful to replace assets but we're going to be patient.

Matthew Howlett -- *Nomura Instinet* -- *Analyst*

Are you getting any benefit from your propriety securitization shelf in terms funding costs? Are you seeing -- or is that potential to improve returns long-term?

David Finkelstein -- *Chief Investment Officer*

You're talking about the resi business?

Matthew Howlett -- *Nomura Instinet* -- *Analyst*

Yes.

David Finkelstein -- *Chief Investment Officer*

Well, yeah, so just giving you a little bit of history of that business. We started it predicated on FHLB financing, which is obviously highly beneficial relative to warehouse lines and even entails a lower cost than securitization. But what we're seeing in the securitization market over the last year to two has been a significant pickup in the securitization sector for resi credit. And spreads continue to tighten liquidity continues to improve.

Net supply in residential credit is likely to be positive this year, where it's -- up until last year it was declining year-over-year from diminishing legacy RMBS. And now we actually do have what we think to be a healthy securitization market and that's indicated by the success of the last couple of deals we've done.

So the financing rates are not quite as -- not as attractive as FHLB financing, but we do get a better advance rate, and its non-recourse leverage, and it allows us to be more nimble and further deploy our capital and continue to securitize.

Matthew Howlett -- *Nomura Instinet* -- *Analyst*

Great. And just one question on the dollar rolls. Should we -- how should we think about that modeling sort of flat going forward given the pools just have the much better carry?

David Finkelstein -- *Chief Investment Officer*

Yes. Dollar rolls, exactly, it's essentially coupon minus implied financing rates and the decline in our dollar roll income was a function of a couple of things. Number one, was the rate hike late last year, which increased implied financing rates from that standpoint, as well as a decline in specialness in the first quarter a pretty meaningful decline that we've experienced over the last number of quarters.

This quarter however there is a little bit of specialness in the market, but we don't expect it to persist. And so you probably would think of dollar rate roll income to be somewhat flat so long as the Fed doesn't move.

Matthew Howlett -- *Nomura Instinet* -- *Analyst*

Thanks a lot.

David Finkelstein -- *Chief Investment Officer*

You bet.

Operator

The next question comes from George Bahamondes with Deutsche Bank. Please go ahead.

George Bahamondes -- *Deutsche Bank* -- *Analyst*

Hi. Good morning. Just a follow-up question on a response little while ago here. There were some comments around concern with volatility. Is this broadly just credit markets or they're specific pockets of the credit markets that you were referring to there just wanted to see if you can provide some additional either color or detail possible?

Kevin Keyes -- *Chairman, Chief Executive officer and President*

Well, George, I think my commentary was just overall in the market among virtually every asset class. I think, it's not like it's new news for us to see risks throughout the credit market. I think we just think that there is momentum money, which is non-fundamental that has continue to drive financings and valuations in terms and structures that on the credit side that we're wary of.

I think the biggest thing though beyond that I think is just the disconnect. When I talked about correlations, the disconnect in risk assets, the value of risk assets versus lower risk assets. And we're a company that -- in times like these where there's no volatility and there is a rush to chase every kind of high growth IPO that's out there regardless of the value, people tend to not pay attention to us.

And then in times like the fourth quarter of 2018 or the first quarter of 2018 or the about times of volatility that's when our valuation actually and our attention actually increases. So I think the thesis here is that, we're a market leader, we dwarf the size of most, no one is as diverse as we are, of course, there is risks. We have to manage just like everybody else. But we're not a one-trick pony. We're not over-levered in any sector by any means. And at the end of the day we're waiting for that volatility. When it hits that's when we pounce.

And the two most volatile timeframes in the past couple of years, as I've said, over and over first quarter 2016, first quarter of 2018 is when we made some large acquisitions of companies that were not prepared and were not run in a conservative way. So I could go on and on about the different risks and different pockets, but I think to answer questions just in general, this is a risk on market based on momentum. We are a defensive liquid low-beta stock that if you want to have an insurance policy that's why you own us in the least of the cases.

And I think this reset on our cash flow is really us commentary on the risks that aren't priced into the market as we see it. And we don't want to have a dividend that bounces all over the place like most other companies. We want to have a portfolio and a posture and a disposition that is overly conservative and you can rely upon it. In a market right now, which is really

the opposite in a lot of different ways, it's just amazing to me that here we are in the beginning of May and every one has already forgotten about what happened a couple of months ago.

And it seems like that has -- this 24-hour news cycle is really affected people's dispositions and mentalities not to mention the dark pools and the structured finance that goes around the asset market. So long story short, I think we see a lot -- we've seen a lot of risks but we see frankly more lack of vesicle reality out there and we're just -- we're waiting for the next period of volatility and that's where we thrive. And we'll be patient and pay you a very good carry while we wait.

George Bahamondes -- *Deutsche Bank -- Analyst*

Great, appreciate the color this morning.

Operator

The next question comes from Rick Shane with JPMorgan. Please go ahead.

Rick Shane -- -- *Analyst*

Hey good morning guys and thanks for taking my question. Look, I really appreciate the focus on preserving capital. Is it fair to say that the dividend cut reflects a disconnect in terms -- a timing disconnect that from a longer-term perspective, you see risk in your credit-sensitive opportunities and not great risk-reward there for now and that ordinarily in this type of environment or that facing that environment you lean into the agency book, but given the flat curve and the expectation and so prepayments picking up, doesn't make sense to do that right now?

Kevin Keyes -- *Chairman, Chief Executive officer and President*

Yes. I think that's -- you're pretty much spot on Rick. And you know us better than anyone in how we operate. We're very proud of our track record and this whole diversification strategy allowed us to outperform in a market that wasn't without challenges. And looking forward, we just want to have the optimal flexibility with our capital to focus on the next phase and the next stage of this company. And the next stage of this company is going to

be what we're telegraphing is continued diversity ultimately lower levered portfolio once credit cheapens up here.

And in the last two months, it's tightened 30%. By the way, the equity market is up 30%. So that's the correlation that doesn't make sense to us in the near term. So what we're doing is we're setting the table for the longer term, optimize our flexibility. In this position now we're very confident that protecting our book value and producing this premium yield is achievable.

Before a couple of years ago, as rates -- as the Feds lifting and even from liftoff on, the market was picking its sides whether you wanted book value protected or you wanted yield and it was tough really to deliver both. We think with this reset we can -- we're in a better position to deliver both today than we have been. Since these credit businesses have scaled and when we choose to maneuver, we can do so and move the needle quite dramatically. And that's me telegraphing that we think the next period of volatility with all this embedded leverage in the system, there's a multiplier effect with the impact to those other companies that aren't as liquid as we are as diversified as we are.

So I'm anticipating -- we're waiting for it and we'll go buy another company. We'll go get another big partner and we will continue as I said over the longer term be the go to guy. I don't know why you would want to own some of these other companies heading into the next set of storms that ultimately will come and they're going to come.

Rick Shane -- -- *Analyst*

Okay. And from a more tactical perspective, it's great from strategic perspective, from a tactical perspective brought the hedge ratio down a little bit. Is that going to be the posture for the near term given the current rate environment?

David Finkelstein -- *Chief Investment Officer*

Yeah Rick this is David. As I said earlier, the risk to Agency MBS is a rally in the market. And so we do need to be a little bit long to protect that and it's ironic because the way this business model work, the agency business model work is you got paid for taking agency-basis risk and traditionally you

get paid for taking duration risk. We happen to be in an environment today where you're actually paid to hedge because LIBOR you receive is a touch about where you're going to pay.

And so the unfortunate part of this is we have to be a little bit long to protect the portfolio in the event of a rally, but that actually costs money to provide that security and it just is what it is. So also it's notable that duration exposure and times of the steep curve would add 200 to 300 basis points in your levered return and that's another reality of the flat curve as you just don't get that return and it can be a cost.

Rick Shane -- -- *Analyst*

Got it, OK. Thank you very much guys.

David Finkelstein -- *Chief Investment Officer*

You bet.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Kevin Keyes for any closing remarks.

Kevin Keyes -- *Chairman, Chief Executive officer and President*

Thanks everyone for joining the call today and for your support of Annaly and we look forward to speaking to you all again next quarter. Thanks.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

Duration: 54 minutes

Call participants:

Jillian Detmer -- *Head of Investor Relations and Marketing*

Kevin Keyes -- *Chairman, Chief Executive officer and President*

David Finkelstein -- *Chief Investment Officer*

Glenn Votek -- *Chief Financial Officer*

Bose George -- *KBW -- Analyst*

Mark DeVries -- *Barclays -- Analyst*

Douglas Harter -- *Credit Suisse -- Analyst*

Matthew Howlett -- *Nomura Instinet -- Analyst*

George Bahamondes -- *Deutsche Bank -- Analyst*

Rick Shane -- -- *Analyst*

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Is Annaly Capital Management a Buy?

A REIT with a dividend yield over 11% might sound pretty enticing, but is it worth adding this massive dividend payer to

your portfolio?



 **Reuben Gregg Brewer** (TMFReubenGBrewer)

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 [Author Bio](#)

A big piece of investing is balancing risk and reward. When investors look at **Annaly Capital Management** ([NYSE:NLY](#)) and its huge 11% dividend yield, this fact needs to be front and center in their minds. Although this company is a [real estate investment trust](#) (REIT), it isn't exactly your typical REIT. Here's what you need to understand before jumping on the chance to add this huge yield to your income portfolio.

What do you really own?

The vast majority of REITs are landlords. They own physical assets that are leased out to tenants. If a tenant were to stop paying, then the company would simply find another tenant or sell the asset (even without a tenant, most properties tend to hold their value fairly well). Most property REITs generate pretty stable income over time and have the backstop of owning a real asset. This is one of the big reasons why investors like REITs. They provide a way to own a diversified portfolio of investment-grade rental property -- and benefit from the income such assets throw off -- without having to do any of the legwork.



IMAGE SOURCE: GETTY IMAGES.

Annaly doesn't do that. [It is a mortgage REIT](#), buying and selling mortgages, not properties. To be fair, many traditional, property-owning REITs also invest in mortgages, but the exposure to mortgages is generally tiny relative to the physical assets they own. A pure mortgage REIT is very different from the idea most investors have about real estate investment trusts.

A typical REIT will use debt to build its portfolio. That debt may not be directly backed by the properties it owns (as a mortgage would be), but it owns physical assets that have intrinsic value. In a worst-case scenario, it could sell these assets to repay its debts. A mortgage REIT also uses debt (generally a lot of it), but it uses the loans it takes out to buy other loans (such as mortgages). It's making the spread between its interest costs and the rates it earns on the loans it buys with that cash. In theory, this is a simple and potentially profitable operation.

However, one big problem is that a mortgage is basically just a piece of paper. The only thing backing a mortgage is the ability and willingness of the borrower to continue paying the loan. Yes, there is an asset backing that loan (such as a home), but evicting a borrower and taking possession of

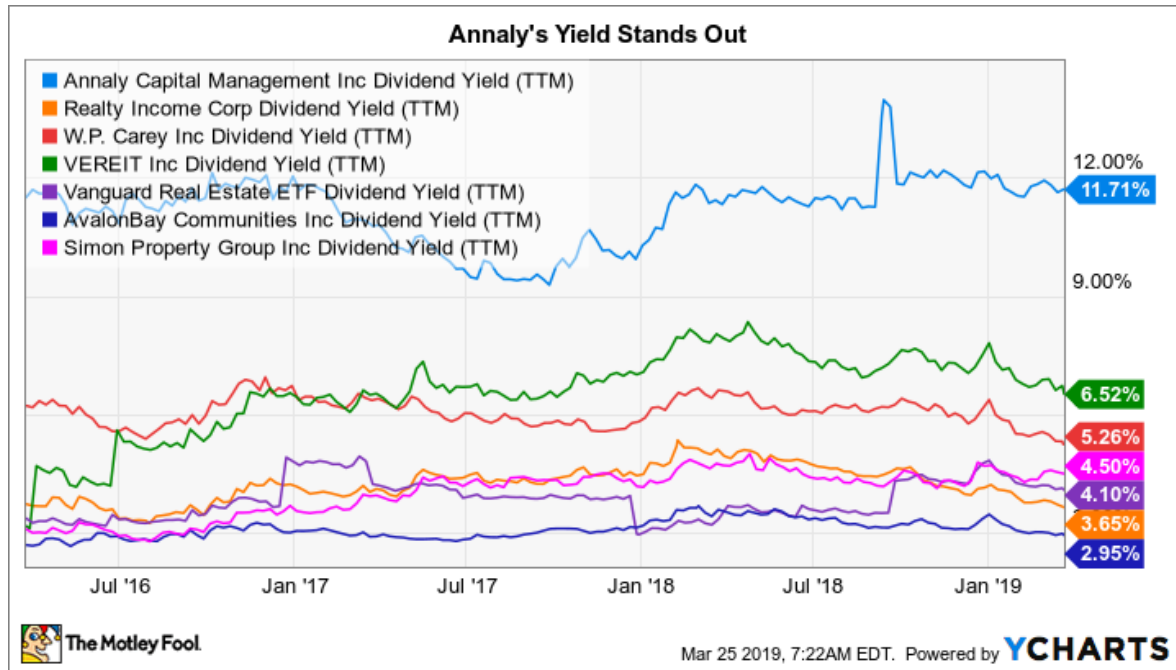
that asset is a long and often difficult process. And even then, it isn't necessarily reasonable, since Annaly often buys loans that have been pooled together into collateralized loans (this, as you might expect, complicates the process of dealing with delinquent borrowers). Selling a loan that isn't being paid, meanwhile, isn't a great thing either, since such non-performing loans often trade for pennies on the dollar relative to performing loans. In other words, there's not much of a backstop for a mortgage REIT if something goes wrong.

The deep 2007-09 recession was a lesson in what can go bad with this business model. Although, to its credit, Annaly survived the so-called Great Recession, a number of notable mortgage REITs declared bankruptcy when a large number of homeowners couldn't, or chose not to, pay their mortgages. If you are a conservative investor who doesn't want to spend a lot of time monitoring your portfolio, then you should simply avoid mortgage REITs like Annaly. Stick to REITs that own physical property.

Check out the latest earnings call transcript for [Annaly Capital Management](#).

But that 11% yield!

If you are still enticed by the huge dividend yield offered by Annaly, however, there's more to the story to consider. Annaly operates four distinct divisions: Agency, Residential Credit, Commercial Real Estate, and Middle Market Lending. This gives a bit of diversification to the portfolio. However, more than 90% of its assets are in the Agency business, so that's its big driver.



DATA BY [YCHARTS](#).

This is probably a good thing, overall. The Agency business buys collateralized loans backed by government agencies such as **Fannie Mae** and **Freddie Mac**. It's one of the largest players in the space, which it considers defensive because of the implied government backing of the loans. That said, if Annaly's funding costs go up because interest rates are changing, its margins will get squeezed and its profits will fall.

This is because the rates on the mortgages it buys are locked in for 20 to 30 years, while its funding costs are more variable. Yes, low interest rates can be very beneficial, but rising rates are not a good thing. That said, this has to be juxtaposed against the fact that the rates borrowers pay on new loans fluctuate with interest rate changes, as well. As rates fall, Annaly ends up replacing expiring loans with new ones at lower interest rates. That's not a good thing, either. There are complex interactions at work, and the impact of interest rates is a key factor that has to be managed constantly. It's the main issue with which management has to deal.

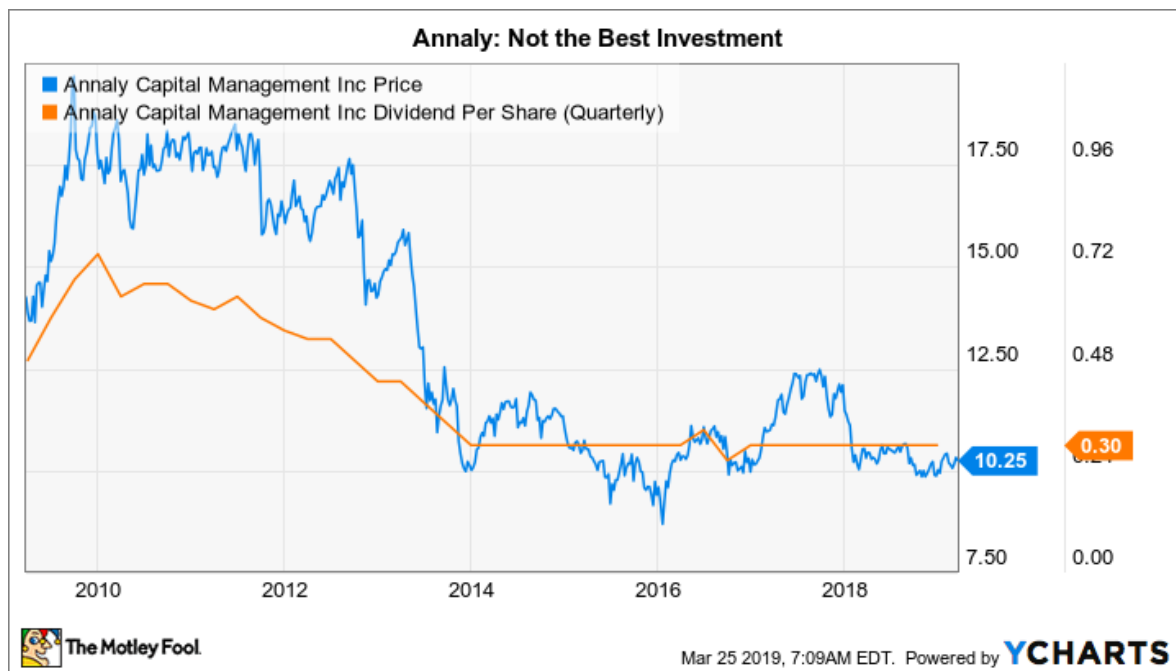
The other businesses the company operates are much smaller, but generally take on more risk. For example, Residential Credit buys loans that aren't backed by a government agency. If something goes wrong (like a

recession that leads to an increase in defaults, for example), there's no backstop. Commercial Real Estate invests in loans backed by business assets, a very different property type. While an individual might make the emotional decision to tighten his or her belt to keep current on a loan (saving the home and the equity built up), a struggling business is more likely to make a business decision and declare bankruptcy. That could quickly leave Annaly in a tough position.

The Middle Market group, meanwhile, originates loans to companies based mainly on their ability, and willingness, to pay (not physical assets). The company considers this business defensive, but that might prove overly optimistic in a recession. That said, these loans generally have floating rates, so the risk of rising rates is offset somewhat, although it's possible for rates to rise so much that a company stops paying.

Although the idea of buying mortgages and loans is pretty simple, it isn't really as easy as it sounds. Interest rates and the economic outlook can have a huge impact on the income Annaly shareholders receive in dividends.

Speaking of which, here's a closer look at the company's dividend.



DATA BY [YCHARTS](#).

The REIT's dividend has been held at \$0.30 per quarter per share since 2014. But don't get too complacent. It was \$0.75 per quarter per share at the start of 2010, heading generally lower for several years before settling at \$0.30. If you had owned the shares since late 2009 (the end of the Great Recession), your income would have been cut by 60% while the company's share price was trimmed by a painful 48%. Sure, the dividend has been steady for the past several years, but history suggests most investors would be better off sticking to a REIT with a lower yield and a stronger dividend-paying history.

Just not worth the risk

If you are looking at Annaly because of the REIT's huge yield, stop. This is not a typical REIT; it borrows money to invest in loans -- a very different REIT business model that hasn't performed particularly well in recent years. Annaly's dividend history and share price attest to that. The REIT has managed reasonably well, and [some market watchers are quite fond of it and its business model](#), but most investors would be better off sticking to far more boring property owning REITs. If you do decide to invest here, however, remember that interest rates are a huge issue that you'll need to keep in mind because of the outsized importance they play in Annaly's results. This is not a set it and forget it type of investment.

Reuben Gregg Brewer has no position in any of the stocks mentioned. The Motley Fool has no position in any of the stocks mentioned. The Motley Fool has a disclosure policy.