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Are New REITs Too Risky?

By Ben Levisohn

They beckon with their muscular double-digit yields, mocking those of the 10-year Treasury. But they also are massively risky, and the hefty payments aren't likely to last forever.

In a gun-shy investing world, should you even bother considering mortgage real-estate investment trusts now?

Yes, say advisers—as long as you take precautions.

Mortgage REITs raise money through initial public offerings, and then load up on pools of mortgages. Using those mortgage-backed securities as collateral, they then borrow more money and buy more bonds. They repeat the process until they have up to eight times as much debt as equity and can pay a dividend of 10% or more.

The post-financial-crisis environment has been ideal for mortgage REITs, especially those that purchase securities issued by government-backed mortgage giants such as **Fannie Mae** and **Freddie Mac**. Interest rates are low, allowing them to borrow cheaply, while the so-called yield curve—the spread between borrowing costs and the money that can be made on long-term mortgage-backed securities—is steep.

In its Aug. 2 second-quarter earnings announcement, for example, **Annaly Capital Management** Inc. said it paid 1.62% for its funding while yields averaged 3.79%, a spread of 2.17 percentage points. During the same period five years ago, the difference was 0.32 percentage point. Likewise, **Capstead Mortgage** Corp. had a 1.66-point spread during the first half of 2011, up from 0.04 point in 2006.

Yet tempting though it may be, the mortgage-REIT business model brings big risks. It relies on low borrowing costs and a ready supply of funding; anything that impairs the spread can send REITs spiraling down, as investors fear for the safety of their hefty dividend yields.

The worst-case scenario for mortgage REITs is a sudden rise in rates. That would make the bonds that REITs own worth less, and could force selling to meet margin calls.

On July 29 and Aug. 8, mortgage REITs plummeted for a different reason: fears that the market for "repurchase agreements," where short-term borrowers go to get cash from money-market funds and other lenders, would freeze up in the event of a U.S. default, making it impossible for REITs to borrow money to keep their leverage up. On July 29, Annaly plunged as much as 18.6% before snapping back, while **Hatteras Financial** Corp. fell as much as 14% before recovering.

Now investors have an additional worry: that falling Treasury yields could cause homeowners to refinance and force REITs to replace higher-yielding bonds with lower-yielding ones. "REITs stand to do well in a range-bound rate environment," says Qumber Hassan, a strategist at Credit Suisse. "They would like rates to remain unchanged."

The interest rate on a 30-year fixed-rate mortgage averaged 4.46% this week, down from a peak of 5.23% in February.

Yet mortgage REITs' yields are still alluring. Right now, Annaly pays out 14.87%, while **American Capital Agency** Corp. boasts a 19.71% dividend, according to Morningstar Inc.

If you must dabble in mortgage REITs, there are some ways to reduce the risks. For starters, investors should think of mortgage REITs as part of their bond—not stock—allocation, and a small part at that.

For instance, after making sure clients who are enticed by the juicy yield understand the risks, Sam Katzman, chief investment officer at Constellation Wealth Advisors LLC in New York, recommends they devote no more than 3% of their bond portfolio to any individual REIT. "We size it like a high-yield bond," Mr. Katzman says. "If you're comfortable with the risks, you get your yield."

Advisers also caution investors to be wary of an IPO boom. Nine mortgage-REITs went public or filed IPOs this year, according to data provider Dealogic, backed by **Allianz** SE's Pacific Investment Management Co., or Pimco, and **Putnam Investments** LLC, among others. That, says Jeffrey Gundlach, chief executive of DoubleLine Capital LLC and a veteran of more than 20 years in the industry, may signal a peak for the sector—and he is passing on the opportunity to get in on the action.

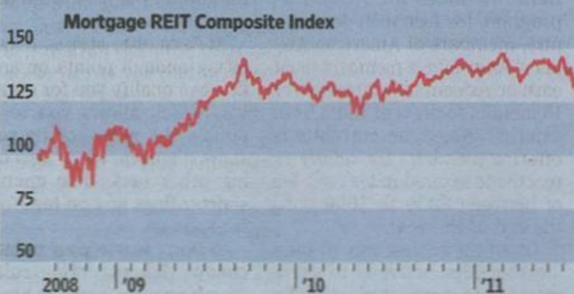
"I'm too old to raise money then go around the world and apologize," he says.

Like any investment product, investors also need to pay attention to fees. Most REITs charge investors a hefty amount for the privilege of having their money managed. Of the nine REITs that have filed for an IPO or gone public this year, at least eight are charging a 1.5% management fee.

Many others add steep incentive fees that can eat into returns. Coming offerings from Pimco and **Provident Mortgage Capital Associates** Inc., for exaample, will charge additional incentive fees of about 20% on profits. Advisers say investors should look for lower-fee alternatives, such as Hatteras Financial, which has cut its fees as it has raised equity.

High Yield, High Risk

Mortgage real estate investment trusts, which offer dividends as high as 20%, have been a stable source of income since the financial crisis. But they're subject to sudden price swings in times of stress.



Source: Credit Suisse Group via WSJ Market Data Group