

An Introduction to Mortgage REITs

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MARTINSVILLE, N.J., May 11, 2011 /PRNewswire/ -- Considering the low yields currently offered by many traditional fixed income investments, income-seeking investors have been scouring the investment universe for increased income generating power. One largely uncovered corner of the market that may fit the bill for such investors is Mortgage Real Estate Investment Trusts (mREITs). Much like other forms of REITs, these companies are required to distribute 90% of their net income to shareholders to maintain their tax advantages or exemptions, as outlined in the Internal Revenue Code. However, whereas equity REITs invest primarily in physical properties, mREITs achieve their income through investments in mortgage-backed securities. Given the hefty dividends offered by many of these vehicles, with some yielding in excess of 15%, they are an attractive option for investors seeking a high level of current income. However, before diving in head-first, it is important to discuss how these companies operate and understand their potential risks.

In general, mREITs operate by taking out short-term loans and using the proceeds to purchase mortgages, thus profiting from the spread between their short-term financing costs and the payout of the underlying mortgages. The degree to which they use debt to finance their activities is known as their leverage, or debt-to-equity ratio. While many of these investments offer comparable yields, the path they take to get there may be starkly different. Consider two such vehicles: Cypress Sharpridge Investments (CYS) and Chimera Investment Corporation (CIM), both of which yielded between 16% and 18% in 2010. Whereas CYS invests primarily in high-quality mortgages backed by the government, CIM primarily deals in lower-quality, higher-yielding, non-agency and commercial mortgage-backed issues (CMBS). However, by employing leverage of 8.3 to 1 as of 12/31/10, CYS attains a similar yield to CIM – which carried leverage of 1.2 to 1– despite the divergence in yield of their underlying investments. Another option, Invesco Mortgage Capital (IVR), falls somewhere between the two and uses a hybrid approach that blends a mix of agency, non-agency, and CMBS securities based on their interpretation of current market conditions. Likewise, IVR's 4.1 to 1 leverage ratio falls between that of CYS and CIM.

When evaluating these varied approaches, investors should weigh their relative tolerance to credit risk vs. interest rate risk. Since CYS invests in agency-mortgages, whose principal is backed by the federal government, its credit risk is relatively low. However, because it employs a high degree of leverage, a sharp increase in short-term interest rates could severely crimp its profits. While many mREIT investors remain concerned that the end of QE2 in June could push short-term rates higher, it is important to remember that the Fed's Treasury purchases during QE2 have been largely focused on issues maturing between 2 and 10 years. As such, movements in short-term rates should continue to be a function of investor preference for short-term T-Bills and the Fed's decisions on the Federal Funds Target Rate, which Fed Chairman Ben Bernanke has expressed his commitment to keeping the target rate low for an "extended period." Conversely, while rising short-term interest rates also pose a threat to investors in CIM, which invests in non-guaranteed MBS and CMBS issues, credit risk remains a much larger source of concern. Such investments, which carry a higher default risk, allow CIM to reach a similarly higher yield with a much lower degree of leverage due to the higher payout of its underlying investments.

Investors should note that since the dividend payments made by such companies are a direct function of their operating profits, they can fluctuate over time along with the strength of its underlying business.

After all but going extinct during the recent financial crisis, when a credit market freeze cut off their access to short-term funding, mREITs are making a comeback as more investors seek out their high yielding potential. With that being said, mREITs have accounted for 7 of the 9 initial public offerings within the REIT space thus far in 2011. Individuals can invest in mREITs by buying shares directly on an open exchange or through an ETF which tracks a basket of companies in this area. However, investors need to keep in mind the aforementioned risks associated with mREITs when deciding which one, if any, is right for their portfolio.

At the time of this article, Condor Capital Management held long positions for its clients in CYS, CIM, and IVR.

Condor Capital

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