http://www.sec.gov/cgi-bin/ruling-comments?ruling=s7-34-11&rule_path=/comments/s7-34-11&file_num=S7-34-11&action=Show_Form&title=Companies%20Engaged%20in%20the%20Business%20of%20Acquiring%20Mortgages%20and%20Mortgage-Related%20Instruments

To : Securities & Exchange Commission

From : Bill O'Connor , private investor , [redacted]

Re: File No. S7-34-11 : Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments

I am a private investor who has owned / traded virtually all mortgage REITs in existence (as well as some no longer with us) over the last 13yrs. Prior to this, I worked in mortgage sales and trading at various large broker dealers for another 15yrs thus I find myself uniquely qualified to comment on mortgage REITs and their exemption from the 40 Act.

To begin with , I applaud the SEC for at least asking openly some questions about the world of special funding vehicles like BDC's and the various types of mortgage REITs out there that use investor money to acquire a myriad of investment assets . Its been my opinion the sector is woefully misunderstood and full of conflicts in terms of what gets reported to investors as asset values / book values vs. where those assets would trade if they needed to to delever some .

To begin with, its very important that the SEC and investors understand that risk comes in 2 flavors, interest rate risk and credit risk and both can / have destroyed companies in the recent past that did not understand this.

Orange County went bankrupt via interest rate risk …… it owned nothing but AAA rated GSE investments but blew itself up being overly levered as rates rose . Drysdale Securities famously blew up being excessively levered in nothing but US Treasuries. Going the other way , we saw mortgage REITs like Thornburg Mortgage blow up despite owning what was described as 'Super Prime' mortgage loans made to what it suggested were affluent clientele via credit risk . We also saw numerous subprime and Alt-A mortgage REITs go bankrupt in recent years as well, all from credit bets gone bad.

Thus it should be very clear that one can go bankrupt running a subprime mortgage REIT just as easily as overly leveraged players owning nothing but US government securities. Credit and interest rate risks can kill with equal deadliness.

My letter is focused on mortgage REITs. They tend to fall into three categories.

1) Agency Only REITs (amREITs) . Players include NLY, ANH, CMO, HTS, AGNC, and CYS.

2) Hybrid REITs. Players include IVR, TWO, MFA, DX, and MITT. They tend to have a majority of their capital (80-90%) in GSE mbs and the rest typically in non-GSE residential mortgage bonds.
3) Pure credit play mortgage REITs. CIM and RWT in residential and CXS, NRF, ARI, CLNY, STWD, NCT, RAS in commercial mortgage bonds/loans.

A cursory glance at the balance sheets above would show the amREITs tend to run leverage somewhere in the 6-7 to 1 leverage range. The hybrids tend to be 5-6 levered and the pure credit anywhere from <1 to 2 to 1 leverage. I define leverage as total liabilities vs. shareholder equity.

Since the SEC made its announcement to seek public comments, the markets in all mortgage REITs have been pummeled. This has happened as dealer research departments and the blogosphere have gone public with statements how mortgage REITs will be crucified after the SEC orders them to clip leverage.

This is happening at the worst possible time for our country. These mortgage REITs are absorbing tens of billions of bonds that buyers are needed for to help the US economy recover, to keep home mortgage rates low. What the SEC has inadvertently done is assure that the sector will hold off adding more assets as well as possibly seek to shrink some in size in advance of an adverse SEC decision. This I cannot emphasize enough the need for the SEC to move swiftly to put closure to the can of worms it has opened vs. leave more uncertainty out there .

It's my belief (and that of some good research people on Wall Street) that if changes were made , the group who should be allowed to continue to run high leverage is the pure agency REITs (group 1 above) because they have a demonstrated ability to thrive even in times of credit stress because of the incredible liquidity available to them . It's a subtle point lost to most stock investors who see leverage at a company like NLY at 6x1 and freak out ……completely oblivious to the fact NLY could take their leverage down to 3x1 in a few hours of selling. At other end of spectrum, pure credit play companies would need weeks or months to sell much of their assets and would probably run the risk of getting badly depressed prices for the assets if the sales were conducted under duress (i.e. MUST SELL TO RAISE CASH).

GSE mbs securities are among the most liquid in the world. In times of extreme credit market scares when big banks go 'no bid' on non-GSE debt, I have personally observed big institutions buy billions in US Treasuries and GSE mbs passthrus and big banks accommodate them. Same institutions seeking to sell non-GSE residential debt or commercial mortgage debt during credit scares face 'no bid' replies. In short, the liquidity of GSE mbs is well established when it's needed the most vs. 'everything else '.

Thus what SEC should consider (assuming it decides to change anything) is to leave the pure GSE REITs alone and let them run whatever leverage they see prudent (I have seen as high as 12 or 13x1 in the past). Aside from the fact these REITs have a demonstrated history of performing VERY well for investors; they also serve a fabulous service to the needs of the country! By being in the business of buying Fannie and Freddie mbs bonds, these REITs are holding down interest rates at a time this country desperately needs help keeping those rates to encourage new buyers of homes to emerge. The SEC should be very aware by now that Fannie and Freddie are going to shrink in size and possibly even cease to exist down the road and that new buyers of the billions in paper these entities hold today will need to be found. REITs like NLY need to be encouraged to exist as well as new ones to form. These companies now own close to $200 billion in Fannie, Freddie and Ginnie Mae bonds and the country does NOT need or want to see these players shrink and sell paper.

I would assume the SEC has looked at long term agency REITs like NLY, CMO and ANH and seen the huge outperformance to the general stock markets. In the last 10 years, NLY has generated a 308% return for investors, CMO has returned 213%, and ANH has returned 180%. Against this, the S&P 500 has returned a meager 38% and the Dow Jones just 41%.

Keep in mind that retail investors are among the biggest holders of these REITs thus its been a real win for the small guys. These REITs have served a huge social benefit to the country absorbing hundreds of billions of FNM/FRE mbs debt, and they have outperformed the broad markets by wild margins.

In short , the current pain inflicted on this space by SEC regulatory uncertainty borders insane given how well space has done and its history through crisis periods as well as the need for these companies to help keep mortgage rates low for middle class buyers at a time the country is desperate to help the housing markets .

As for hybrid REITs and pure credit play REITs, I would think the lower leverage seen in those sectors shows the markets are somewhat self policing. Should SEC impose some leverage limits on these types of REITs? Maybe. But it will be very complicated to do so.

My personal belief is that pure credit play REITs are the riskiest group because their assets are nearly impossible to ‘ mark to market ‘ accurately and thus where there is greatest risk of blowups . They tend to be the group that has almost irrational plunges in share price during scares. Look at Thornburg Mortgage (TMA) who was very highly regarded in the business until people finally realized they were running double digit leverage on a portfolio of non-GSE jumbo mortgages. They went from being considered among the best to bankrupt in record time and in hindsight, many of us scratched our heads at how they could have ever thought double digit leverage in non-GSE mbs could work. So what is the correct leverage for the next TMA? Hard to say. Surely single digit but the difference between 3x1 and 9x1 is massive.

Also, the SEC may find itself pulling in more than just mortgage REITs. Look at the biggest property REIT in the US markets today (by market cap) Simon Properties (SPG). Bloomberg shows they have $18.9 billion in total liabilities vs. $5.7 billion in shareholder equity for a total leverage of 3.3 to 1. But the truly scary aspect of SPG is that their stated book value is $16.18 while the stock is trading at $118 for a premium to book value of 730%!!!! Keep in mind almost all mortgage REITs trade right around book value. My money says SPG would face great difficulty liquidating assets in today's property markets at prices that support a $118 share price. You could see massive plunges in share prices of blue chip REITs like SPG if delevering had to take place. Why should only mortgage REITs be put under the gun? Especially when the world of commercial RE prices is VERY ILLIQUID and we know banks carry theirs at greatly inflated prices. How else does Bank of America have a stated book value over $20 and a share price of $7? If I was at SEC, I'd be scratching my head as to the extreme premiums to book value the big property REITs somehow command while even JPM trades at a healthy discount to book value and be very worried about all the moms and pops that have piled out of banks and into 'safe REITs' pushing them up to levels I shake my head at.

Finally, I want to emphasize the difference in valuation of assets among the 3 REIT categories.

The amREITs have book values set by the GSE bond markets. They are about the only book values in the public stock markets whose numbers can be completely trusted because the assets are priced BY THE MARKETS. Once you move into hybrid REITs and pure credit play / commercial mortgage REITs , many (if not all) of the assets are getting priced by management , by computer models , or by estimates from Wall Street that are miles above where same broker dealer would actually buy the asset (never mind the question of where a BBB rated CMBS bond should be marked on bid side , offer side , mid market , etc) .

In short , the SEC should know that book values at amREITs are real …… at hybrids they are probably 90% accurate with only the 10-20% in non-GSE stuff getting priced to 'estimates ' and then in the pure credit play areas difference between book value and 'liquidation value' could be enormous …… 20% ? 30%? Who knows …… thus why they run low leverage.

But plays like SPG at enormous multiples to book value and virtually all assets extremely illiquid? I'd suggest they are the riskiest of the REITs bar none in current environ and the massive discount to book values that the big banks trade at proves it (who is probably the next biggest players in terms of exposure to commercial real estate).

In conclusion: Rapidly respond to the uncertainty you have created and continue to keep pure agency REITs exempt. If you want to place a limit on leverage of say 15x1 or so, fine….do it. But take away the uncertainty you have created in a group that play a vital role in US economy at moment and as Fannie and Freddie go away will be even more necessary to be a natural buyer of these bonds. I would expect at some point, the folks in Washington DC are going to notice you are harming this sector and ask you to stop sooner or later too.

As for hybrid REITs, maybe limit leverage to single digits for any that have more than 30% of their assets / revenues coming from non-GSE mbs. They can then decide whether being a hybrid vs. a pure agency REIT is more profitable and move on.

As for pure mortgage credit REIT as well as all other REIT types, they probably should run leverage of 3x1 max given their track record of blowups in most recent credit crisis as well as past credit crisis. Just keep in mind that you may snare some REITs like Simon Properties in the process and that could unleash a lot of screaming and yelling.

Please feel free to call me if you want further clarification on anything I have said. Above all, please resolve this quickly before you damage the agency REIT space on a more permanent basis and actually ruin something that is working great, has a stellar history, has been a home run for retail investors, and most importantly serves a national purpose.

Bill O'Connor