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BTN Thursday Thoughts

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Exploiting Inefficiencies Created by ETFs (Exchange Traded Funds)

Crowd: If she weighs the same as a duck, she's made of wood!
Sir Bedemir: and therefore…?
Crowd: she's a witch!
Sir Bedemir: Gooood!
-from *Monty Python and the Holy Grail*- (1975)

Exchange traded funds (ETFs) have become very popular as a cost-effective way to gain exposure to a specific market, index, or industry. ETFs are often built largely with computer screening and well-defined rules for what goes into the portfolio. This minimizes active management decisions and allows the ETF to operate with a defined portfolio of both stocks and weightings for each. When investors buy an ETF, the cash inflow generates purchases for every stock in the portfolio. That works in reverse too, as selling an ETF position means every stock in the portfolio is sold on the market. The goals are to keep the weightings of the portfolio positions constant, and have the fund trade at a 0% premium/discount to the underlying portfolio of securities. We will not wade into the active vs. passive management debate in this installment. However, in our opinion, there is no doubt that the blind trading of the ever-growing passively-managed asset base is leading to material inefficiencies in certain securities which can be exploited by astute active investors who are willing to do their homework.

As noted above, many ETFs are constructed to mimic the performance of certain industries or security types. **However, there are times when companies may have the same or similar SIC codes (Standard Industrial Classification) and therefore go into the same ETF portfolio, despite having very different operating models.** For example, there are several passive portfolios that hold MLP (Master Limited Partnership) structured companies. MLP's are typically associated with oil and gas pipelines, and therefore tend to trade in-line with the price of oil. However, there are several

companies with MLP structures whose operations do not have the same demand/supply characteristics as the traditional MLP. For example, CVR Refining (CVRR) is an MLP with refining assets in the Midwest. Golar LNG Partners (GMLP) leases floating liquified natural gas regassification units and carriers. Teekay LNG Partners (TGP) maintains a fleet of natural gas carriers. None of these companies have the same exposure to the price of oil as the stereotypical MLP, yet all are included in various MLP ETFs.

A very simple relationship conflict that appears in an MLP portfolio is lower natural gas prices encouraging more demand from utilities. However, utilities using more natural gas means they will use less coal. Thus, MLP ETF investors may be buying more of a coal company when its business gets weaker and selling coal when results are improving because they are buying or selling the whole portfolio based on gas trends. Likewise, refineries normally perform better when oil prices are falling, which would run counter to the oil-related MLPs in the ETF portfolio.

In our view, ETFs are likely here to stay and these types of inefficiencies will continue to happen. **We consider this an opportunity to find misunderstood stocks that are being unfairly rewarded or punished by being bought and sold in these passive portfolios.** While the timing is uncertain, even ETF portfolios have turnover in positions which may release some of these non-conforming stocks from the irrational trading relationships they are under now.

We believe Starwood Property Trust (STWD) is a prime example of a company that is being punished for being included in ETF portfolios. The company is classified as a Mortgage REIT, and most ETFs in this group attempt to track an index of all Mortgage REITs with 30-40 positions. There are two primary types of Mortgage REITs that operate very differently–Residential and Commercial. Both seek to borrow money and invest it in mortgage instruments at a higher rate and thus earn a spread. That is about where the similarities end.

The largest of the Mortgage REITs focus on buying residential mortgages. Most, but not all residential mortgages carry mortgage insurance, have a loan that is less than 70% of the home value (loan-to-value ratio), and/or are further guaranteed by Fannie Mae or Freddie Mac. Thus, the risk of default losses is very low. The mortgages are themselves packaged into large portfolios that issue bonds backed by all the mortgages in the portfolio. The result is the bonds being purchased by the Residential Mortgage REITs normally carry interest rates very close to the 10-year government bond yield. So how does a REIT investing in 3% mortgage bonds manage to pay a dividend of 7%-12%? The answer is leverage.

Using some simple numbers, the Residential Mortgage REITs will borrow short-term money of say 30-180 days at less than 1%, and buy even more mortgage bonds earning 3%. They may leverage their equity base 5-9x under this type of operating model. Thus, a company with $100 million in book value may borrow $600 million at 1% and buy $600 million of mortgages at 3%. This produces cash flow of $12 million ($600 million * 3% is $18 million earned less $600 million *1% is $6 million in interest expense). This nets to $12 million in cash income over $100 million in book value for a 12% yield.

The risk for Residential Mortgage REITs is changing interest rates. Many of their mortgage investments have fixed rates. If rates fall, homeowners refinance their loans. Thus, the Residential Mortgage REIT sees the money earned on its portfolio decline, and it may fall more than the funding costs. So instead of earning a 2% spread (3% - 1%), it may earn only 1.5% (2.25% - 0.75%). Suddenly, the yield on the book value is only 9%. What's more, Residential Mortgage REITs are not immune from rising rates either. When rates increase, fewer people prepay mortgages, which means the portfolio yield will remain flat while the funding costs increase. This also results in the net spread decreasing. When rates increase, it also stretches out the effective life of the portfolio due to lower prepayments. Now, the company may have a portfolio with an average life of 14 years which is yielding 3% with rates increasing instead of a portfolio with a 5-year life yielding 3%. In that environment, the value of the portfolio will fall, which reduces the REIT's book value as well as the amount it can borrow. Plus, the lower book value, smaller spread, and limits on leverage can lead to lower dividends. The result of all this is Residential Mortgage REITs can be some of the most cyclical investments around, as their high dividends can fall quickly, resulting in capital losses for the stock.

This is not to say that Residential Mortgage REITs never offer value or upside. Nor is our simple illustration of risks that impact them designed to be a full security analysis of every company in the world of Residential Mortgage REITs. However, looking at two ETFs for this group, iShare's REM and VanEck's MORT, shows that Residential Mortgage REITs dominate the weightings in the group. REM has only 40 positions, and the top 10 make up 70% of the ETF by weighting with 53.3% residential and 16.7% commercial. Similarly, MORT has only 27 positions, and the top 10 make up 59% of the ETF with 43.1% as residential and 15.8% commercial. Starwood is the number three position for both ETFs at 8.05% and 5.57%, respectively.

Starwood has a very different operating model that operates with much less leverage. It has also never cut its regular dividend even with the various levels of turmoil in interest rates, both real and perceived, since its formation in 2009. Compare that to the two largest Residential Mortgage REITs, Annaly Capital Management (NLY) and AGNC Investment Corp (AGNC):

Table 1

	2009	2010	2011	2012	2013	2014	2015	2016	2017
STWD	$0.11	$1.20	$1.74	$1.76	$1.82	$1.92	$1.92	$1.92	$1.92
NLY	$2.29	$2.65	$2.51	$2.17	$1.65	$1.20	$1.20	$1.20	$1.20
AGNC	$5.15	$5.60	$5.60	$5.00	$3.75	$2.61	$2.48	$2.30	$2.16

Starwood even paid some special dividends in both 2013 and 2014 that are not included in the above figures.

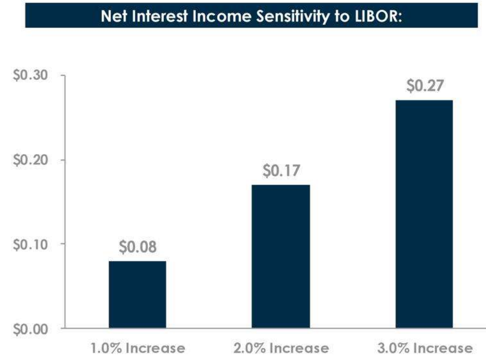
STWD's earnings benefit from interest rates increasing. The bulk of the loans that the company invests in are floating rate, meaning as rates increase, so does the interest income. Also, there are floors set on the loans so that they cannot fall to zero if interest rates decline. STWD also has better

credit quality than its peers, and has fixed rates on many of its financing methods. The result is a lower cost of funding and again more leverage toward rising interest rates.

Exhibit 1

Interest Rate Sensitivity

- The Company will continue to benefit from a rising interest rate environment
  - 92.6% of the Lending Segment's commercial loan portfolio is indexed to LIBOR



NOTE: Based on assets and liabilities as of September 30, 2017

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Exhibit 1 above shows a table that appears in all of STWD's earnings presentations, which highlights that the current environment is more likely to produce higher earnings for STWD even if it may be hurting some of the Residential Mortgage REITs.

In terms of leverage, STWD also looks more attractive. As opposed to Annaly earning a gross interest spread of under 2% and leveraging that heavily to generate a 10% dividend, STWD produces gross cash yields of 6%-10% and requires much less leverage to produce its 8% yield.

STWD makes loans on commercial properties. Currently, 82% of the loans are first mortgages with a loan-to-value of only 63%. STWD is earning 6.7% on these loans and produces a 10.9% yield by only leveraging 1.6x. The remaining part of this portfolio includes 3% subordinated loans earning 11.4% without leverage and a loan-to-value of only 40%, and 9% mezzanine financing earning 11.2% without leverage and a 65% loan-to-value. Commercial Mortgage Securitization bonds are the remaining 6% of the portfolio and are a pool of several loans. STWD is earning 5% on these bonds and has leveraged them to a 12.1% yield. STWD also has direct ownership of several properties earning a cash yield of 10.5%.

The net result is STWD does not have to leverage its book value to the same degree as the Residential Mortgage REITs. The company's debt/equity ratio was 1.6x as of 3Q17. That compares to 6.9x at Annaly and 8.0x at AGNC, the two largest Residential Mortgage REITs that dominate the weightings in the ETFs. Also, all these companies issue stock to expand their portfolios at times,

and other times have repurchased their stock below book value. Tracking book value over time should give some insight into which companies have more volatile earnings and loss potential:

Book value per share

Table 2

	2011	2012	2013	2014	2015	2016	3Q17
STWD	$18.68	$19.90	$16.42	$16.84	$17.37	$17.70	$17.33
NLY	$16.86	$15.85	$12.13	$13.10	$11.73	$11.16	$11.42
AGNC	$27.71	$31.64	$23.93	$25.74	$22.59	$21.17	$19.78

Dividends and losses reduce book value per share. STWD raised some new capital to expand in the last year, and also paid a special dividend in 2013 of $5.768. Also keep in mind that STWD has never reduced its dividend, while the other two are paying half what they were in dividends just a few years ago. Regardless, STWD's book value per share has been on an upward trajectory since 2012, while NLY and AGNC are decidedly below their 2012 levels.

We are also struck by the various well-touted studies telling investors that the long-term return of equities has been about 9% for nearly a century. Also, half that return has come from dividends. Dividends represent lower risk forms of investment income because it is much easier to forecast 90-days out that a recurring dividend will be paid than projecting many years into the future for capital appreciation to occur. In the case of STWD, it is yielding 8.9% in cash, which is basically offering the long-term rate of return for equities in cash every year.

STWD has also not been a destroyer of capital or stock value. The book value has held up, and the stock has essentially been above $20 for most of the last four years. It does not have the same risks as the others in its group and, in fact, their risks are positives for STWD. The company out earns its dividend and carries much less leverage. Many of these positives are lost because of passive portfolios trading the entire Mortgage REIT sector as one basket. CEO Barry Sternlicht summed up the issued well on the 3Q17 call:

> "*– in mortgage or yield ETFs, we're one of the largest players now. We're number three. So we get whipped a lot with people's expectation where rates are going and when the resi REITs, which don't have positive [correlation] to the rising interest rates get crushed - We get sold off with them and it's a blind trade. It's just programmatic and it's has nothing to do with our underlying assets. It was amusing as people thought rates were going up, sort of amusing that we were going down with the residential REITs and most of our peers' earnings were not down with rising rates. The ETFs don't care. They just – we're all on the same bucket, and they just sell us based on our market caps.*"

“What’s fascinating about it is that the debt markets think we’re a stud and the equity market treat us like we’re a junk-bond, so it’s a fascinating situation because our debt has traded great and continues to tighten and tighten and our stock continues to sort of be a puts [ph]. So, trading at almost a 9% dividend yield, so I think it’s a ridiculously compelling investment. If it was – I’ve never understood why the stock didn’t trade at 6% dividend yield given the diversity [of earnings] and where rates are and the amount of money in the market and the lack of yield [opportunities].”

In our view, there is some hidden value in STWD stock, and the fact that ETFs trade it incorrectly is an opportunity. Irrational connections do not last forever, and in the meantime, investors get paid 8.9% annually to wait on the full value to be realized. If Mr. Sternlicht is correct and the stock was to trade at 6%, the price would jump from $21.60 to $32, which is nearly 50% capital appreciation potential as well.

Update on Ocean Yield (OCY NO)

In the last few weeks, Ocean Yield has reported several notes of positive news. When we wrote our initial report, we noted that the company for the first time in recent memory had no new ships on order. That is important because growth is largely dependent on adding more ships to the fleet on long-term charter.

On December 1, 2017, the company announced it would acquire three new-build oil tankers that will enter 10-year charters with Nordic American Tankers. This follows the traditional operating model for Ocean Yield in dealing with new ships and it was able to secure some sizeable discounts on the purchase. Both situations should boost IRR and minimize risks if the ships ever had to be resold/rechartered.

The oil tanker business is currently oversupplied and day rates are below normal. Ocean Yield normally looks at situations like this as opportunity to acquire vessels cheap and work with high-grade credit counter parties who want to use Ocean Yield’s balance sheet. Nordic American has one of the lowest debt levels per ship in this cyclical industry. More ships are being scrapped industry-wide at this point, and Nordic chose to do maintenance on many of its ships during the downturn in charter rates. Now, as 2018 starts, charter rates appear to be improving and Nordic’s finances should also improve. More than likely, the new ships will replace older vessels that will be scrapped and not add to an oversupply situation.

Ocean Yield also announced in recent weeks that the *Lewek Connector* has a new short-term contract for 130 days starting March 1, 2018 and an option for another 130 days. This was one of the two vessels at Ocean Yield with a charter problem as the original charter party is restructuring. The long-term goal is to sign a new long-term charter, perhaps with the original party as discussed in our initial report. Ocean Yield has seen some gaps in revenue from this vessel during 2017 as a result. The current situation is not a surprise as the early part of the year is a seasonally

slow period, and it appears that 2018 will begin with the ship idle also. The company has already taken a write-down to reflect a lower fair market value for the cash flow the ship is earning at this point. EMAS Chiyoda, the original charter-party, announced in December 2017 that restructuring continues. Some parts are being sold and new investments are coming to other parts of this unit. The *Lewek Connector* is going to remain a wildcard for Ocean Yield until a multi-year contract is found. However, the news going into 2018 continues to look better than coming into 2017. Plus, the addition of 17 new ships in the last year has more than offset lower rates for the *Lewek Connector* and also makes 2018's forecasts look better than late 2016-early 2017.

There has been no formal change to the outlook for the *Dhirubhai-1* FPSO vessel. Several factors continue to point toward a favorable outcome, including the current field where the vessel is working still has more work to do after the current contract expires in September 2018. The charter partners are looking to not only continue working the current field, but are also spending $6 billion to develop three additional fields in the area that will also need FPSO work. The *Dhirubhai-1* is being considered for this work as well. The charter partners have the option to purchase the vessel, which would result in $255 million in cash inflow for Ocean Yield. The vessel will be debt-free by then. The proceeds could be redeployed in new vessels to generate future cash flow. Otherwise, it is likely that the *Dhirubhai-1* will get new charter work in the area and continue to produce cash flow for Ocean Yield. There should be more news on this front in a few months.