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EDITED TRANSCRIPT

AI - Q4 2019 Arlington Asset Investment Corp Earnings Call

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PRESENTATION

Operator

Good morning. I'd like to welcome everyone to the Arlington Asset Fourth Quarter 2019 Earnings Call. (Operator Instructions)

I would now like to turn the conference over to Rich Konzmann. Mr. Konzmann, you may begin.

Richard E. Konzmann - *Arlington Asset Investment Corp. - Executive VP, Treasurer & CFO*

Thank you very much, Olivia. Good morning. This is Rich Konzmann, Chief Financial Officer of Arlington Asset. Before we begin this morning's call, I would like to remind everyone that statements concerning future financial or business performance; market conditions; business strategies or expectations; and any other guidance on present or future periods, constitute forward-looking statements that are subject to a number of factors, risks and uncertainties that might cause actual results to differ materially from stated expectations or current circumstances.

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I would now like to turn the call over to Rock Tonkel for his remarks.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Thank you, Rich. Good morning, and welcome to the Fourth Quarter 2019 Earnings Call for Arlington Asset. Also joining me on the call today is Brian Bowers, our Chief Investment Officer.

During the fourth quarter, as improved economic outlook as a result of Federal Reserve monetary policies and lower global trade uncertainty led to a risk on move in the global financial markets, which drove an increase in the 10-year U.S. treasury rate and a steepening of the yield curve. The 10-year U.S. treasury rate increased 26 basis points during the quarter, ending at 1.92%. And the 2- to 10-year U.S. treasury curve steepened 31 basis points.

In addition, swap spreads widened 8 basis points benefiting agency MBS portfolios hedge with interest rate swaps.

On the funding side, the Federal Reserve's [0.25 point] rate cut in October, along with its actions to provide substantial liquidity to the repo funding markets were significant positive steps to funding in our business.

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Against this backdrop, price performance of mortgages was strong in the fourth quarter as the spread between the yield on agency MBS and benchmark interest rates tightened meaningfully with pay-up premiums on specified pools performing particularly well in light of the rise in mortgage rates.

Since the start of the new year, global economic concerns surrounding the impact of the coronavirus and other macroeconomic factors have led to a rally in the 10-year U.S. treasury rate and some retracing of the steepening of the yield curve that occurred in the fourth quarter as well as higher market prepayment speed expectations for agency MBS. Against this backdrop, agency MBS have performed relatively well in early 2020.

Turning to our actual results for the quarter. We reported GAAP net income of $0.72 per share and core operating income of $0.18 per share.

Core operating income was unchanged from the prior quarter as the benefits of both lower funding costs and G&A expenses were offset by lower asset yields and leverage.

As of year-end, book value was $7.86 per share, an increase of 7% from September 30, reflecting the tightening of agency MBS spreads.

The company's total economic return measured as the change in book value plus common dividends declared was 10% during the quarter.

As of today, the company estimates that its book value per share has increased approximately 1% since December 31.

Short-term recourse leverage, measured as the company's repo financing and TBA commitments less cash to total investable capital, has moderated to 8.7x as of December 31 from 9.9x as of the prior quarter end. The weighted average CPR for our specified agency MBS portfolio was 12.11% during the fourth quarter, a decline from 12.85% in the prior quarter.

Although our agency MBS asset yields benefited from these lower prepayment speeds, the weighted average effective asset yield on our agency MBS for the fourth quarter declined to 2.81% compared to 2.96% in the prior quarter, due primarily to a shift to lower coupon agency securities.

To begin the fourth quarter of 2020, the company's weighted average CPR was 10.47% for the months of January and February, which we expect would result in a weighted average effective asset yield of approximately 2.84% for that period, a modest increase from the average yield in the fourth quarter.

Given current interest rate levels, we expect continued elevated prepayment speeds. However, our transition in the agency MBS portfolio to lower coupon specified pool securities with lower premiums should moderate increases in prepayment speeds going forward and their impact. And our shift in strategy to incorporate mortgage credit investments should reduce agency MBS prepayment sensitivity in our book value and earnings over time.

With its shift in agency MBS investment concentration towards lower coupon securities that carry lower prices, pay-up premiums and prepayment risk, the company's investment in lower coupon, 2.5%, 3%, 3.5% coupon MBS was 72% of its total agency MBS portfolio at December 31, an increase from 57% at the prior quarter end.

In addition, all of the company's agency MBS investments as of year-end were in specified agency MBS with favorable prepayment characteristics as the company did not hold any generic TBA securities that are more sensitive to higher prepayments.

During the fourth quarter, the company's weighted average repo rate was 2.09%, an improvement from 2.46% in the prior quarter as the company's funding costs benefited from the Fed's rate cuts. However, term repo funding rates were somewhat elevated at year-end with the company's weighted average agency MBS repo rates at 2.1% as of December 31.

Repo funding rates have improved since year-end, with the company's weighted average agency MBS repo funding rates at approximately 1.75% currently.

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As of December 31, 83% of the company's repo funding was hedged with interest rate swaps and the company's weighted average fixed pay rate of its interest rate swaps was 1.82% during the fourth quarter, unchanged from the prior quarter.

During 2019, we highlighted the company's increased focus on and evaluation of mortgage credit opportunities across various sectors. Consistent with that, during the fourth quarter, the company actively shifted its investment strategy to incorporate a broadened spectrum of mortgage credit assets in addition to its focus in recent years on agency MBS.

Initially, the company's expanded strategy encompasses specialty mortgage assets across a limited number of selected sectors, which better leverage the company's long-standing relationships, skills and resources.

Recognizing that the current economic and investment climate is constructive but mature, we are particularly focused on tailored or directly originated opportunities with attractive and protective credit characteristics, and where possible, sourced or created in partnership with specialists in their fields with long experience originating, underwriting, financing and servicing in their investment disciplines.

Arlington has had lengthy relationships with these partners, in many cases, decades long. Some of these areas of investment focus may have future branding opportunities for Arlington and its partners as well.

Taken together, we believe a basket of these especially selected, directly originated and tailored opportunities will diversify the company's risks, reduce leverage, enhance returns and earnings as well as reduce prepayment, volatility and repo financing exposures for the company.

These sectors include specialty real estate lending segments such as large single asset, single borrower CMBS transactions, small balance commercial CMBS, industry-focused and specialized direct originated commercial real estate loans as well as residential property-backed mortgages, like business purpose, residential transition and non-QM residential mortgages.

These assets offer significant characteristics such as attractive LTVs, cash coverage and total debt ratios with targeted ROEs ranging from approximately 11% to 16%. They also offer diversified funding sources, including permanent financing in certain cases, and they are generally either liquid or offer access to liquidity.

The company began selectively allocating capital to these mortgage credit opportunities with potentially higher risk-adjusted returns during the fourth quarter.

As of December 31, capital allocated to the company's mortgage credit investments totaled $57 million, representing 14% of the company's investable capital.

The company's mortgage credit investments as of year-end, consisted primarily of single-asset, single-borrower commercial mortgage investments and small balance commercial MBS with attractive risk-adjusted returns.

To start the year, the company has continued to evaluate and add new mortgage credit opportunities as it believes the risk-adjusted returns are higher than current agency MBS returns.

During the fourth quarter of 2020 (sic) [2019], the company invested in an equity investment in a nonagency securitization, collateralized by business purpose mortgage loans, also known as residential transition loans secured by residential homes for which the borrower holds the property for investment purposes. Following these initial mortgage credit investments, we have observed overall improved returns on invested capital, combined with a reduction in the overall corporate leverage by almost 2 turns since the beginning of the fourth quarter, with this prospect of potential further reductions in leverage as mortgage credit investments expand.

The company is optimistic about the return opportunities available to shareholders from a prudently executed shift to a broader and more active investment strategy, which now includes a discriminate focus on mortgage credit investments as well as agency MBS.

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In summary, the company's initial disciplined investments in mortgage credit opportunities totaled 14% of investable capital with ROEs expected of 11% to 16% and attractive credit characteristics.

Second, Arlington has sourced or co-invested in these initial investments with a number of premier partners and is currently in discussions with additional potential partners for direct originations of credit assets.

Third, observed returns on invested capital have increased and overall leverage is down by nearly 2 turns following the company's initial mortgage credit investments.

Fourth, agency MBS spreads are currently attractive with spreads wider than historical averages. In addition, Federal Reserve actions to cut interest rates and provide liquidity to the repo markets have significantly lowered the company's current funding costs and a supportive economic landscape should be a tailwind for our mortgage credit investment strategy.

And finally, cost efficiencies are available in 2020 to reduce the expense burden on capital and enhance the company's returns to shareholders.

In summary, the company is positioned to benefit from improvements in current net interest spread returns in agency MBS as well as opportunistically investing in selective mortgage credit investments at potentially incrementally higher relative returns, which should allow the company to deliver attractive returns to its shareholders.

Operator, I would now like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will now go to our first question. Our first question comes from Josh Bolton with Crédit Suisse.

Joshua Hill Bolton - *Crédit Suisse AG, Research Division - Research Analyst*

I appreciate the disclosure in the deck around the incremental levered returns on agency versus credit. Curious, do you have a target percentage of capital allocation for the credit segment? Or how are you thinking about how large that bucket could grow? And then additionally, do you have any thoughts around the pace of growth that we could see in that segment over the next 12 months?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Well, obviously, Josh, the pace of investing and the ultimate exposures will depend on the market conditions as they evolve over the course of time. The conditions being as they are today, we would continue to expect that the mortgage credit investment portfolio would grow as returns in that segment are at least equivalent to, if not higher than agency returns and offer other appealing characteristics that I noted in the script and so I think that would be, today, the first focus. And I wouldn't put a number on it, but I wouldn't suggest anyone be surprised if they see that portfolio grow in investable capital over the course of the year on a prudent basis based on where opportunities may be and may grow as high as double over the course of time. That's an ongoing process. As you know, it's dynamic, but -- and it would be a prudent process of a potential expansion in that portfolio. But we can see that it may grow materially over the course of the year to the extent that opportunities continue to be relatively more attractive on the credit side versus the agency side.

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Joshua Hill Bolton - *Crédit Suisse AG, Research Division - Research Analyst*

Got it. That makes sense. And then just one on the interest rate sensitivity disclosure. Looks like during the quarter, the portfolio shifted to be much more negatively exposed to higher rates. Curious if that's something intentional reflective of your macro view of rates or just any commentary around the rate environment and how your agency portfolio is positioned would be great.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

I guess my first comment to that would be that actual performance in agencies in down rate scenarios has probably underperformed versus modeled expectations that you see in these standard presentations, and the opposite is true. The historic -- recent historical experience has been that they have tended to outperform in up rates or steepening environments to a certain extent and to a certain level. So I would say that this posture reflects the recent experience, the convexity embedded in these assets today and the difference -- the observed difference between actual prepayment developments and market expectations as rate changes and curve shape changes have occurred.

I'd say it also reflects a broader commentary, a broader observation on the macroeconomic backdrop. It is a consequence of all those things. We've driven the coupon -- the average coupon, the average price, the average pay up in the portfolio down sort of programmatically over the last couple of quarters, and that's ongoing with a focus down primarily to the 3% coupon spec pool block of assets.

Operator

Our next question comes from Trevor Cranston with JMP Securities.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Wondering if you could provide some more color around the new credit strategies in terms of how we should expect those investments to be structured. It looks like at December 31, the assets are to show up on the balance sheet as MBS and mortgage loans, but I was curious because you described them as co-investments if the expectation should be that those will continue to show up as MBS and loans or if there's potential for things like joint ventures to be showing up on the balance sheet at some point.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

I think for now, probably expect more of what you've seen described in the financials that -- I suppose, that could potentially change over time. But for now, for the immediate term, anyway, I think, probably expect to see securities and mortgage securities and mortgage loans represented as you saw them in the fourth quarter.

Rich, do you have any different commentary on that?

Richard E. Konzmann - *Arlington Asset Investment Corp. - Executive VP, Treasurer & CFO*

No. I think that's right. Literally, in our next quarter or so, but down the road, certainly opportunities for more of the latter, what you spoke of, Trevor, in terms of more direct investments in joint venture type of opportunities.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

We alluded to a -- discussions ongoing with new potential investments and partners and some of those would be exactly along the lines of -- that you have described, Trevor. But those may take a bit of time to further develop.

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Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. Got you. And then as these develop and you said that you're working with sourcing partners, should we expect there to be any additional expenses showing up on the income statement associated with the new strategies? Or how is that going to play out?

Richard E. Konzmann - *Arlington Asset Investment Corp. - Executive VP, Treasurer & CFO*

Yes, I think -- this is Rich, Trevor. You may see a little bit more G&A cost associated with it, but I think there's -- going to be offset with some savings you'll find in other places. There's certainly some more diligence costs and other types of things that we have to incur as it relates to expanding into various mortgage credit opportunities. But again, I think those costs will generally be offset in the end by savings that we'll see in other places.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

No, I think that's right. I think there will be higher -- somewhat higher cost around the initiation and the origination of those assets and potentially around personnel. I don't think -- I don't expect it to be dramatic at all. And I do think there are opportunities for other expenses to run down over the course of '20 as it compared to '19. And so I think in the end, you'll probably -- more likely than not, you'll see cost savings come through on a net basis over the course of 2020 because I think the potential cost savings will exceed or meaningfully exceed incremental expense required to initiate and originate and undertake these investments, including potential joint ventures.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. Got you. And then the last question on the MBS structured investments you've made so far. Can you say where you've been investing in the capital structure? If it's more towards first loss-type investments or if it might be higher up?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

It depends. It's variable. I'd say it does include sort of elements of the capital stack down toward the first loss, but in very low LTV situations, and it includes nonfirst loss positions in those with a bit higher LTV characteristics. And in either, what we're looking for is the combination of LTV, seniority and cash coverage levels that we're entering into an investment with a higher LTV, but then we're expecting that those cash coverage levels would be quite high and other factors that may offset that.

Some of these opportunities are also relatively short. And we like the short -- sort of relatively short duration of that credit exposure. And some of the others that are longer, have more moderate and attract lower LTVs and other characteristics. So it's a nice blend of duration and attachment point and generally low external -- very low external leverage on those and attractive cash flow characteristics attached in any of -- all of those cases.

Operator

Our next question comes from Christopher Nolan with Ladenburg Thalmann.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Rock, when you are on the new credit strategy, when you're discussing joint ventures and so forth, are you talking about partnering with property developer or so and investing in equity? Can you clarify that for me, please?

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J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

With -- I think it would be along the lines of partnering with originator-, servicer-type folks principally for lenders, in particular, specialist fields, that sort of thing, rather than sort of equity and real -- commercial real estate development, that's probably not top of the list. It's probably not even present on the list at the current time. But investments -- co-investments or joint ventures with originator, servicers and specialty lenders in their field, who have long track records and appealing asset characteristics are the kinds of things we have engaged in and expect to continue to engage in.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Great. And also, will this new strategy include things like the Freddie Mac K-Series, which would require -- into the lower tranches would require consolidation of the securitization on your financials?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

It's something that we have reviewed, the K-Series. We have not participated in it down -- thus far. I wouldn't rule it out potentially down the road, but thus far, it's not been a principal focus to date, and I would say isn't right at the moment.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Great. Final question. ROE targets...

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

We feel like, Chris, that we can derive better opportunities in other comparable, but not K-Series securities loans.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Okay. Finally, earlier, about a couple of quarters ago, you gave sort of guidance for high mid-single digit, slow double-digit ROEs, any update to that?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Well, I think we hit on it in the script by alluding to the fact that the returns available in the mortgage credit segment at -- under current conditions, seem to us to be in the range of the low- to mid-double digits. We stated 11% to 16%, we think that's representative. I think agency returns on the other hand, while they have improved, the prepayment speed uncertainty is still meaningful and that creates risks that are different from the mortgage credit environment and probably -- and 11% is the top end of what one might be able to achieve on a new dollar invested in agency in a lower coupon head security spec goal.

So you just -- that volatility, we feel, in the present environment is lower in the credit side and the returns are the same or higher. So far, our experience has been, as I said in the script, that they're higher with lower leverage and other appealing characteristics. So we think sort of the programmatic nature of evaluating and undertaking originating these assets will be beneficial over time. And to the extent that the agency returns evolve over time from high-single digits to maybe 11% at the max today, then we'll continue to consider that. But for now, the primary focus under current market conditions and returns for credit assets would be first on the credit side and the ventures -- and the discussions and ventures we have in progress with the potential partners as we speak.

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Operator

Our next question comes from Jason Stewart of JonesTrading.

Jason Michael Stewart - *JonesTrading Institutional Services, LLC, Research Division - Senior VP & Financial Services Analyst*

Rock, you talked about, obviously, the joint ventures, it sounds like the true business migration into credit, but at the same time, you mentioned it might have been an opportune or it sounds like it could have been an opportune time to acquire credit assets in the fourth quarter. Could you go through maybe those 2 different points as it relates to the commercial versus the equity investment and it sounds like SFR? Just how those 2 played out in terms of the cadence of investments -- investing, so we could get a sense for how that might play out going forward in the return profile?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

So we've -- I think what I tried to say in the script, Jason, is that we're investigating across all these spectrums, right? So we're investigating the single asset -- the specialty CMBS, single asset, single borrower, small commercial, in particular, direct originated, tailored or sort of specialized industry-specific commercial mortgage loans, that's sort of one bucket and then on the other hand, loans that are secured by residential property, i.e., business purpose, residential transition loans, potentially non-QM. And right at the moment, SFR is not the top priority but it's possible. It's in the spectrum of things we're evaluating. It's probably something that isn't top of our list right at the moment. But we are looking at it. And at some point, it may be appropriate if the returns and risks, justify themselves if that be added to the mix, but not at present, maybe down the road potentially.

Jason Michael Stewart - *JonesTrading Institutional Services, LLC, Research Division - Senior VP & Financial Services Analyst*

Okay. So was there any single asset opportunity that sort of (technical difficulty)?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Say that again, Jason, I couldn't understand the question. You were breaking up.

Jason Michael Stewart - *JonesTrading Institutional Services, LLC, Research Division - Senior VP & Financial Services Analyst*

I'm sorry. Was there a single investment, an opportunistic investment in the fourth quarter? Or was this all part of the strategic thought process?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

I'd say it was, in a way, all of the above, right? This was a process that we highlighted for folks over the course of the middle and latter part of 2019 that we are investigating. We were undertaking discussions with a variety of parties over that period of time. We -- as we completed our -- that phase of our evaluation, we focused on these particular areas. And in the fourth quarter, we came across some opportunistic situations that are quite appealing with experienced sourcing partners, experts in their field. And that provided a particular opportunity. It wouldn't surprise us to see that -- if we were to see more of those opportunities in the course of the first quarter and second quarter of 2020. I'd say those were more in the realm of on the commercial side. And then in 2020, the focus has included the -- those loans secured by residential properties as well, i.e., the fix and flip business purpose securitization that we executed and continue to look at very, very closely and evaluate opportunities intimately in that space.

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Operator

And Mr. Tonkel, there are no more questions at this time.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

I would just say, Jason, one more thing, in each of these silos, what we're seeking is sort of programmatic nature of opportunities with potential partners. It doesn't mean we won't be opportunistic on individual situations that come to our attention, we will be. But we -- what we're seeking to develop is a sort of a programmatic effort here across what we think are attractive credit silos with great characteristics and attractive returns and that will help overall reduce the leverage of the company, improve its returns and diversify its risk. So those are all programmatic focuses that we're seeking to have in place.

Thanks, everybody, for your time. And if you have any further questions, we'll be happy to answer them post the call.

Operator

Thank you, sir. And thank you all for your attention. This concludes today's conference. All participants may now disconnect.

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