THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

EFC - Q3 2012 Ellington Financial LLC Earnings Conference Call

EVENT DATE/TIME: NOVEMBER 08, 2012 / 4:00PM GMT

CORPORATE PARTICIPANTS

Sara Brown *Ellington Financial LLC - Corporate Counsel*

Larry Penn *Ellington Financial LLC - CEO*

Mark Tecotzky *Ellington Financial LLC - Co-Chief Investment Officer*

Lisa Mumford *Ellington Financial LLC - CFO*

CONFERENCE CALL PARTICIPANTS

Steve DeLaney *JMP Securities - Analyst*

Steven Laws *Deutsche Bank - Analyst*

Ken Bruce *Bank of America/Merrill Lynch - Analyst*

Zach Tanenbaum *MLV & Co. - Analyst*

Brad Golding *CRC - Analyst*

Matthew Stolzar *Pyrrho Capital - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the Ellington Financial Third Quarter 2012 Financial Results Conference Call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference call will be open for questions.

(Operator Instructions)

This conference is being recorded today, November 8th. I would now like to turn the conference over to your host, Sara Brown. Please go ahead, ma'am.

Sara Brown - *Ellington Financial LLC - Corporate Counsel*

Before we start, I would like to read the following cautionary statements. Certain statements made during this conference call may constitute forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements are not historical in nature and can be identified by words such as "believe," "expect," "anticipate," "estimate," "project," "plan," "continue," "intend," "should," "would," "could," "goal," "objective," "will," "may," "seek," or similar expressions or their negative forms, or by reference to strategies, plans or intentions.

Forward-looking statements are subject to a variety of risks and uncertainties that could cause the Company's actual results to differ from its beliefs, expectations, estimates, and projections. Consequently, you should not rely on these forward-looking statements as predictions of future events.

Factors that could cause the Company's actual results to differ from its beliefs, expectations, estimates and projections include, among other things, the risks as described under Item 1A of our annual report on Form 10-K, filed on March 14, 2012, and under Item 1A of our quarterly report on Form 10-Q, filed on May 9, 2012, which can be accessed through the Company's website at www.ellingtonfinancial.com, or the SEC's website at www.sec.gov.

Other risks, uncertainties and factors that could cause actual results to differ materially from those projected may be described from time to time in the reports the Company files with the SEC, including reports on Form 10-Q, Form 10-K, and Form 8-K.

We further caution you that statements made during this conference call are made as of the date of this call, and the Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Okay. I have with me today on the call Larry Penn, Chief Executive Officer of Ellington Financial, Mark Tecotzky, our Co-chief Investment Officer, and Lisa Mumford, our Chief Financial Officer. We issued an earnings release yesterday following the close covering several relevant performance statistics for the quarter, as well as some information on our portfolio. We also posted to our website an investor presentation, which we will use during the call.

This presentation also contains some more in-depth information on our portfolio. To better follow this call, it would be very helpful to have this investor presentation with you, which you can access at www.ellingtonfinancial.com. With that, I will turn it over to Larry Penn.

Larry Penn - *Ellington Financial LLC - CEO*

Thanks, Sara. As always, it's our pleasure to speak with our shareholders this morning as we release our 2012 third quarter and nine-month results, and we all appreciate your taking the time to participate on the call today.

In great part thanks to our recent share offering, we also are privileged to have a number of new shareholders and also to have had five additional sell side firms initiate research coverage on our Company. So we send a special thanks out to all of you in both these categories participating on the call today.

In keeping with the format we established earlier this year, we've organized the call as follows. First, our CFO, Lisa Mumford, will run through our financial results. Then, our Co-CIO, Mark Tecotzky, will provide greater color and detail on the MBS market, how we've been positioning the portfolio, and the market outlook going forward. Finally, I'll add some concluding remarks, and then we'll open the floor to questions.

In addition to our earnings release, yesterday evening we posted to our website a third quarter earnings conference call presentation. Lisa and Mark's prepared remarks will track the presentation, so it will be helpful if you have this presentation in front of you and turn to page three to follow along.

Again, you'll find the investor presentation right on the "For Our Shareholders" page, or alternatively on the "Presentations" page of our website at www.ellingtonfinancial.com. While you're getting that in front of you, I'm going to turn it over to Lisa.

Lisa Mumford - *Ellington Financial LLC - CFO*

Thank you, Larry, and good morning, everyone. My remarks will be primarily focused on pages three to five of the presentation.

On page three, you can see that we earned $29.5 million, or $1.59 per share for the quarter, and $72.4 million, or $4.15 per share, for the nine months, and that our earnings were driven by strong contributions from both our core strategies, non-Agency MBS and Agency RMBS. Our non-annualized return on equity for the nine months is 17.6%.

Our non-Agency strategy benefited from interest income and net realized and unrealized gains. Net realized and unrealized gains combined to contribute $1.72 per share to total non-Agency income of $2.01 per share for the quarter. As noted on page four of the presentation, in determining book yields for our non-Agency holdings, which are the basis for the determination of interest income, effective July 1st we adjusted upward our assumptions on forward-looking home prices. We did this given the positive and sustained trends that we have observed in the housing market over the past quarters.

While this adjustment caused an approximate $1.5 million, or $0.08 per share increase in interest income, that income -- that increase was completely offset as a reduction to change in net unrealized gains, therefore not at all impacting our net income for the quarter or nine months. Our net income includes the full impact of mark-to-market investments on our bond and derivative instruments.

We continued to actively trade the portfolio during the quarter, rotating out of securities that in our view became fully valued and rotating into others that we believe still have further upside. As an example, during the quarter, we took advantage of the opportunities to sell some of our holdings of vintage 2005-2007 subprime, and buy certain attractively priced CDOs that had previously been part of the Maiden Lane III portfolio.

We also actively traded securities within our CMBS portfolio, but on a net basis added to its overall size. We ended the quarter with long non-Agency MBS bond holdings valued at $511.8 million, up from $418.1 million at the end of quarter two. This increase reflects two main things -- the partial deployment of proceeds received from our third quarter equity offering and the increase in market prices during the quarter.

In our Agency strategy, our income for the quarter before operating expenses was $5.1 million, or $0.27 per share, and like our non-Agency strategy, this included interest income, net gains from trading activity, and asset appreciation. Our ability to effectively identify and trade prepayment protected Agency whole pools continues to be the driver of our results here. Our weighted average CPR was 8.2 for the quarter. The use of TBAs to hedge interest rates and prepayment risks remains a staple of our interest rate risk management strategy.

We continue to find repo financing readily available, and our blended costs of financing averaged 1.01% over the quarter, compared to 80 basis points in quarter two. This increase was related to the fact that we paid down outstanding repo related to our Agency RMBS during the quarter, thereby making the percentage of outstanding repo related to non-Agency MBS grow to 39.2% at the end of the third quarter from 27% at the end of June.

The repayment of repo related to our Agency portfolio was due to the fact that over the course of the year, we have net sold securities from that portfolio, and the proceeds have been used to repay outstanding repo.

In addition, as of September 30th, we hadn't deployed all of the net proceeds of our third quarter share offering, and pending full deployment to target assets, funds were used to pay down repo. These two things combined with our larger equity base drove our leverage ratio down from 2.24 to 1 at the end of June to 1.33 to 1 at the end of September.

Our blended average remaining maturity of repo outstanding was 68 days at the end of September compared to 45 days at the end of June. Here we took advantage of the opportunity to lock in financing over year end for certain of our Agency RMBS holdings.

Core expenses, which includes other operating expenses and base management fees and excludes incentive fees and interest costs, came in at 2.9% of average equity on an annualized basis. With our current larger capital base, we would expect this expense ratio to be approximately 2.8% going forward. We also incurred incentive fee expenses this quarter after posting returns of over 9% on a trailing four-quarter basis.

I'd just like to quickly touch on our capital usage and a change in how we are reporting it. This is actually on page 22 of the presentation, and here we show you, for the past four quarters, our capital usage across strategies and our debt-to-equity and assets-to-equity ratio. Prior to this quarter, we had a separate capital usage category, which we called "liquidity management."

This category included liquid assets that were held in support of our other strategies, as well as available capital. Because a meaningful portion of the liquidity management capital was really in support of our specific strategies, we have decided to allocate it across those strategies of capital usage and calculate our ratios accordingly.

The result is, we feel, a more comprehensive reflection of our assets-to-equity and debt-to-equity ratios. Now, instead of the "liquidity management" category, we have a category called "additional unallocated capital."

Finally, our diluted book value per share was $23.88 at the end of September, compared to $23.47 at the end of June. Our book value includes the impact of our second quarter dividend in the amount of $0.70 per share, as well as our recent share offering in which we issued 4,025,000 shares and raised net proceeds of approximately $88 million. With that, I turn the presentation over to Mark.

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Thanks, Lisa. Before I quickly walk through some of the slides, I just want to give you some views on the past quarter and sources of return going forward. It was a very strong quarter.

For non-Agencies, there were three major factors that drove performance -

Better housing fundamentals - we've seen eight straight months of rising home prices, progress in reducing shadow inventory, and active buying of REO from numerous deep-pocketed investors.

Two, better technicals - strong buying from money managers and insurance companies that had not been previously buying. Selling from PPIP funds was easily absorbed, and, by the way, there are no large visible further liquidations on the horizon.

And, three, QE3 buying of Agency mortgages has lowered the mortgage rate for prospective homebuyers and competition from the Fed for Agency mortgage assets is crowding out investors from the Agency space and crowding them into the higher yielding corners of fixed-income, specifically non-Agency MBS, CMBS, and high-yield.

It's rare to have such strong technicals, fundamentals and Fed policy all coalesce in the same quarter. But as follows most periods of strong price appreciation, total return risk is now magnified. Some investors will chase performance. Some investors will try to replace lost yield with additional leverage.

For us, the focus is using our infrastructure, trading experience, research, data analysis-in fact all our resources -- to continue to generate strong returns with a strong dividend, when the underlying yields on our portfolio have dropped somewhat. I think EFC's flexible structure and emphasis on relative value trading are going to be more important than ever.

For example, in EFC's Agency mortgage strategy, we can make extensive use of shorting TBA mortgages to manage interest rate risk and prepayment risk at the same time. Specified pools are at all-time high levels. Some bonds are trading as high as $112 dollar price and at the same time you have an aggressive Fed policy designed to both lower mortgage rates and increase prepayments. So prepayment risk is real, it's large, and therefore the flexibility to control that risk with TBA shorts is important and leads us to some great relative value trades.

For our non-Agency portfolio, while we still primarily see the opportunity in the current market as a long risk opportunity, we retain some credit hedges. And obviously, over the life of the Company, credit-hedging has been an important source of return in some years. The flexibility to position the portfolio from both an outright long perspective and from a long-short relative value perspective should be a significant source of returns in today's volatile and uncertain environment.

Now onto the slides. On page 10, the non-Agency portfolio grew, primarily as we invested proceeds from the capital raise. There were no big changes in sector allocations, other than that we added some CDOs that were part of the Maiden Lane III liquidation.

Page 12. Our credit hedges were basically unchanged in size, so given that the portfolio grew, we actually adopted a slightly more long bias in the quarter.

On to page 14. In the Agency portfolio, we shrunk it -- we shrunk things a little bit. The Fed is taking much of the absolute value out of the sector, so we think the proper response is a smaller portfolio with greater emphasis on relative value trades, which now looks more attractive. Relative value in the sector versus swaps and Treasuries has been improving, though, and MBS are now significantly cheaper than their post-QE3 tights.

Page 15. We talked about this before. A TBA short makes sense, and we have avoided being short in significant size coupons that the Fed is buying.

Before I turn things back to Larry, going forward, we see a market with less absolute yield to it, but still lots of trading and relative value opportunities. And as the non-Agency market recovers, we anticipate being presented with new opportunities, new securitizations, including perhaps risk-sharing transactions from the GSEs. Our flexible structure and active trading approach will be more important than ever to driving dividends going forward, and that is our primary focus.

Larry Penn - *Ellington Financial LLC - CEO*

Thanks, Mark. We were very pleased with the positioning of our non-Agency portfolio in advance of the third quarter non-Agency MBS rally. Our rotation beginning last year and continuing this year into lower dollar price and more housing price-sensitive securities has paid off well. As part of that repositioning, we also began reducing and reconfiguring our credit hedges and have kept them at relatively low levels for most of the year.

Our strong quarter's results are a direct result of this repositioning. We continue to believe the current environment to be a favorable one for non-Agency MBS. More recently following this recent rally, we've seen more value in some of the more "off-the-run" sectors, where the prices just haven't risen as much.

While we believe the current environment remains favorable, we also believe that asset and sector selection will become even more important to portfolio returns. While much of the significant price increases that we saw in the third quarter were technically driven, much was also driven by broad changes in assumptions about underlying performance, such as future home price expectations. And given the complexities of the non-Agency MBS markets, these shifts invariably create pricing disparities, both between sectors and on a bond-by-bond basis.

We pride ourselves on our analytics and our ability to identify pricing disparities in the market, and we believe this recent rally has created even more such disparities.

We also continue to see attractive trading opportunities in the CMBS space. And even though our CMBS strategy only represents a small part of our capital base, it's been a very strong provider of returns this year. With our relatively small allocation of CMBS, we've been able to be quite nimble.

For example, we've taken advantage of the uneven new issue calendar by opportunistically adding risk when new issues push down prices. While we increased our CMBS holdings on a net basis during the third quarter -- and this served us extremely well -- more recently, we've been taking some chips off the table in this area.

In Agency RMBS, market yields have only continued to compress since June, and they could remain low for quite some time, especially in light of QE3. We continue to maintain a defensive posture in that strategy. The size of our Agency RMBS portfolio was slightly lower at the end of September relative to June and quite a bit lower relative to the early part of the year. With QE3 and HARP 2.0, we believe that prepayment risk for Agency RMBS has substantially increased.

Even though we've done an excellent job in identifying and trading Agency whole pools with prepayment protection characteristics, we may keep our capital allocation to our Agency RMBS strategy relatively small over the near term.

You can see on slide 22 the decline in our capital allocations to the sector. As of September 30th, approximately 8.1% of our capital was related to our Agency strategy, while at June 30th, 15.3% was related to our Agency strategy. We continue to position ourselves to take advantage more of short-term trading opportunities in the Agency market, rather than long-term value plays.

There's obviously a big risk that prepayment rates will spike substantially, and if that happens, it will inevitably affect some coupons much more than others and some mortgage types much more than others. Meanwhile, the Fed has driven prices up for some securities, such as current coupons, more than others. This all creates tremendous relative value trading opportunities for us. And if we think it's appropriate, we might increase our capital allocation to our Agency strategy.

You'll note that our leverage ratio dropped significantly over the quarter. Since our Agency strategy has historically been the source of most of our leverage, and since our holdings of Agency RMBS have declined, our leverage ratio also declined. To the extent we've become more constructive again on Agency RMBS, we expect that our leverage ratio will tick back up. But in the meantime, it should remain lower.

As most of you know, during the quarter, we completed our first share offering since our October 2010 IPO. We were very pleased to complete this third quarter offering, not just because it provided us additional capital to put to work, but because it increased the liquidity of our shares. Our average daily trading volume has much more than doubled as a result.

The share offering also enabled us to expand our sell side research coverage over the quarter from one analyst to six analysts, and the offering also will result in our having a lower core expense ratio going forward. We believe these all provide significant long-term shareholder value.

We continue to be optimistic on both our near-term and long-term outlook. We have a platform that allows us to be nimble and to take advantage of market opportunities as they arise. We can dial back or increase our credit hedges when and as we see fit, and we haven't been shy about doing so. We are not just buy-and-hold investors capturing a leveraged net interest margin. We actively trade the portfolio, and this has -- and we believe it will continue to be a very significant source of earnings.

We also utilize relatively low leverage in the execution of our strategy, and we have a high rate of portfolio turnover, and we aggressively hedge our interest rate risk. So we feel that our earnings to date have been of the highest quality. We feel good about our dividend level, and we are very excited about the remainder of the year and beyond.

In fact, looking out over the longer term, we believe that it's just a matter of time -- and maybe less time than you might think with the non-Agency MBS market continuing to heal nicely, that the GSEs will cease to be the nearly exclusive bearers of mortgage credit risk as they currently are.

We are highly confident that this will create a wide variety of compelling opportunities for us and that we'll be in a position to capitalize on these opportunities thanks to our flexible corporate structure and strategy.

This concludes our prepared remarks. Before I open up the call for Q&A, I would just like to remind everyone that, as usual, we'll be happy to respond to questions to the extent they are directed to matters related either specifically to Ellington Financial or more generally to the mortgage- and asset-backed marketplace in which it operates. We will not be responding to questions on Ellington's private funds or other activities.

And while we're happy to field any questions about overall market events and trends and our outlook on specific assets classes, as usual, we won't be answering any questions concerning Ellington Financial's performance or portfolio composition beyond the period covered by yesterday's earnings release, namely September 30, 2012. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you, sir. We will now begin the question-and-answer session. (Operator Instructions). And our first question comes from the line of Steve DeLaney with JMP Securities. Please go ahead.

Steve DeLaney - *JMP Securities - Analyst*

Thank you. Congratulations, everyone, on a great quarter.

Larry Penn - *Ellington Financial LLC - CEO*

Steve, thank you.

Steve DeLaney - *JMP Securities - Analyst*

Larry, I've understood in the past that you've stated that the boards -- the Company's policy, the board's -- with the board's blessing is to pay out essentially 100% of earnings. You're obviously not a REIT, so not subject to some of those specific, you know, REIT taxable income rules.

Given the great second quarter and the fact that, you know, ROE year to date is now up to 23 percent, I guess nine-month EPS to $4.15, your dividend is running at about an implied or required ROE of about 12%, so how are -- how's the board and management going to look at this as far as -- you know, do -- just should we assume sort of a one-time -- assuming you have a good fourth quarter, or even if you were just, you know, flat in fourth quarter, it seems there's some excess? And should we anticipate some sort of a year-end special? Or will you just revisit the quarterly run rate dividend? Sorry for the rambling question.

Larry Penn - *Ellington Financial LLC - CEO*

No, no, no, it's -- not at all. So obviously, this is a question that we get a lot. We -- you know, in terms of -- I just want to possibly correct you on one point. We used to have a 100% dividend payout policy.

Steve DeLaney - *JMP Securities - Analyst*

Okay.

Larry Penn - *Ellington Financial LLC - CEO*

And when we -- I believe it was last May -- shifted to a new policy, which was that we were, you know -- we expect to continue to recommend $0.70 until conditions warrant otherwise and that we would basically discuss with the board of directors at the end of the year whether a special dividend was warranted.

Steve DeLaney - *JMP Securities - Analyst*

Okay.

Larry Penn - *Ellington Financial LLC - CEO*

Now, I really can't -- you know, first of all, because it's subject to the whole board, and second of all, because it will, you know, depend upon, let's just say, conditions on the ground, I really can't get into much more detail, but let me just tell you some of the factors that will come into play.

So the first factor that will come into play when deciding about a special dividend is a -- I'll just call it a tax -- a tax issue, which is that we want investors who held the stock over the entire year to be able to pay their taxes on the income that will be passed through to them.

So that sort of puts a constraint on it. And, you know, with tax rates where they are, you know, I would say that would be at least a 50% payout.

And I'm going to be a little bit wide and vague in these ranges, because the second part of the factor that would come into play -- so, you know, so 50% should be, you know, obviously, a lower bound. And then in terms of an upper bound, in a good year like this, we certainly wouldn't expect to pay out more than 100%. Sorry to keep the range so wide.

So where are we in between? So we're going to look at conditions -- you know, where conditions are at the time, which is going to be, you know, probably in February, when we sit down with the board and discuss the special -- you know, if we're going to have a special dividend, and if so how big, and it will be in the context of not only what we have seen in the previous year, but will also be in the context of what we see going forward.

And, you know, as of right now, we think it's an excellent investment environment, but, you know, I think that it's a little premature for me to be having that discussion with you when we haven't, obviously, had it with the board yet in February. So -- but those are the things we'll be looking at, and it will be in the context, you know, as we always do of, you know, is it appropriate to re-evaluate the dividend? To the extent that we are, you know -- well, I'll just leave it at that.

Steve DeLaney - *JMP Securities - Analyst*

Yeah. And, listen, that clarity and framework, the way you laid that out, especially providing the concept of -- given that you are a publicly traded partnership, that you want your investors to have some cash to cover taxes, that's a very helpful framework. I appreciate that.

And just one quick follow-up for Mark. I was with a company yesterday meeting with investors, and the indication from the company was that they had had direct contact with Treasury about these pilot programs that the GSEs may launch coming up to share some credit risk, and the message that was conveyed was that, you know, definitely these programs will hit next year. It's not clear whether the structure will be cash bonds or some sort of CDS derivative.

So I guess my question is, is this something that you all are tracking, you know, more than just casually? And are you seeing it now as possibly, you know, a viable asset class for you?

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Yeah. So I would say, in the past year, we've had specific conversations about it in one meeting. You know, as to whether it's a viable asset class for us, that's all going to depend on pricing.

Steve DeLaney - *JMP Securities - Analyst*

Right.

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

I think what's nice, though, is that -- just if you look at the fixed-income market now, it's basically a daily rock fight for yield. Everyone is looking for yields, right?

And, you know, the Agency originations you know, post-2010 book of business and later, has had excellent performance. So to the extent that there's an opportunity to investors to take some of that credit risk off the books of the GSEs and put it into private hands, I think private investors will welcome that, because private investors right now are in the mode of wanting to take risk, and on top of that, you're getting incrementally, but consistently better news on housing.

So I think risk-sharing from the GSEs, if it references their 2010 book of business and later, would be very well received. So for us, it's whether it turns into a viable investment, that depends on pricing, you know, relative to other opportunities in the marketplace.

I would say that our experience in the CMBS market, where you have a robust new issue market, is that we've liked the pricing lower down in the capital structure. We've been active risk-takers and then active traders of the risk. And that's definitely been something that's been beneficial to the EFC shareholders.

So my hope is that turns out to the same way with risk from the GSEs, but, you know, it's absolutely just going to be a function of pricing for us.

Larry Penn - *Ellington Financial LLC - CEO*

And the fact -- just want to add one thing -- the fact that, as you correctly said, the most efficient structure to -- you know, that might be offered to take advantage of the opportunity might be in the credit default swap market. And, again, since we are not a REIT, we can take full advantage of that. So that --

---

Steve DeLaney - *JMP Securities - Analyst*

I think a REIT has, what, a 5% income limit on derivatives?

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, well --

Steve DeLaney - *JMP Securities - Analyst*

Something like that?

Larry Penn - *Ellington Financial LLC - CEO*

Yeah. So, right. And, you know, obviously you only go into these trades because you expect to make -- you know, you expect to make money, right?

Steve DeLaney - *JMP Securities - Analyst*

Right.

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, so it could -- so they work out very well, it could be a problem, right? So, yeah, so it just sort of puts a limit, and we don't have those limits. So I'm not saying that they can't do it. I'm just saying that, as you pointed out, there are limits that make it more difficult.

Steve DeLaney - *JMP Securities - Analyst*

Listen, guys, thanks very much for the comments.

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Thank you, Steve.

Operator

Thank you. And our next question comes from the line of Steven Laws with Deutsche Bank.

THOMSON REUTERS

Steven Laws - *Deutsche Bank - Analyst*

Hi. To echo Steve DeLaney's comments, congratulations on a very nice quarter. You know, I always appreciate the portfolio detail that you guys do a great job of presenting in your investor presentation. You know, and I think you touched on it some in the prepared remarks. Can you maybe touch on leverage?

So it seems like leverage in the Agency sector came down a little bit. And I realize that might be with how you kind of allocated the capital during the quarter, especially around the -- some new capital coming in.

But can you maybe talk about that and just -- you know, comfort zones for those leverage levels? I know it's -- you know, some of it has to do with a net short position, as well, so I know there's a lot to take into account there with leverage.

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, so -- this is Larry -- yeah, so I guess what I would say is that the way that we think of leverage is, you know, especially because our Agency portfolio is not -- Agency strategy doesn't take up most of our capital, we feel pretty liberated in terms of applying what we think is the right amount of leverage to each strategy.

So, now, how much capital we're allocating to each strategy is something that's very fluid. In our non-Agency strategy, we've been pretty consistent. And if you turn to page 22, which is where the leverage is discussed, you can see we've been pretty consistent in terms of what kind of leverage we've applied in the non-Agency strategy.

As you remarked, it dips down a little bit because of the share offering in the third quarter, but we would expect that to get back to that half a turn of leverage that we often talk about in terms of what we think is a prudent amount of leverage on a, you know, non-Agency strategy that is -- has a lot of, for example, subprime assets that are, you know, assets that have some risk and that also have had some difficulties in terms of financing in the past.

The last thing we want to end up in is a situation where we're forced to sell at a time when the best thing to be doing is buying. So we would expect that to keep that the same.

Now, if the composition of the portfolio were to change, if there were a new asset class -- you know, for example, the GSEs coming in and offering products that we think are attractive or require more leverage, or less leverage, if it's -- you know some sort of synthetic, I mean, you know, we would have to adapt to that.

Steven Laws - *Deutsche Bank - Analyst*

Right.

Larry Penn - *Ellington Financial LLC - CEO*

But -- so but our leverage -- to the extent that our Agency strategy, which is the 10 or 11 to 1 leverage strategy, right, again, very risk-controlled, because it's a lot of TBA shorts there, and we believe, you know, interest rate-hedged, you know, very much so, you know, that would cause them to change.

So as we said on the call earlier, the -- our leverage is really going to be tied, in terms of the bottom line number, currently 1.33, is really going to be tied to the size of that Agency portfolio. And, you know, it's low now, or as of the end of the quarter, it was low.

So, you know, it's really going to be tied to that. The fact that we see at least the risk of a prepayment wave coming, and we think -- and with dollar prices so high, I mean, that's just created a lot of opportunities. So I think there's a decent chance that we will allocate more of the Agency strategy, you know, in a very relative value way, and that could be very, very lucrative, especially if prepayments spike.

So, you know, that's -- but given that it's still a very low level of leverage, we're very comfortable anywhere in this range where we've been, and we think that it's -- leverage is not going to be a significant risk for the Company.

Steven Laws - *Deutsche Bank - Analyst*

Right, appreciate the color on that, especially as you tied in the, you know, different capital and risk profiles of asset classes. One kind of higher-level question. You know, I think -- you know, for most of this year, we've definitely been talking about the election, obviously talking a lot about QE3. Those events are now kind of behind us.

One of the real advantages you guys have is with your partnership structure, the flexibility to be more active with your portfolio management. You know, are there -- what are -- as you guys look out from today -- you know, obviously, I guess fiscal cliff is going to be, you know, one high up the list, but what are other kind of big events on the horizon are you guys looking at that you think could have material impacts on your portfolio that you're kind of targeting now on the calendar as you manage your assets?

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Yeah, so this is Mark. Thank you for the question. One thing that you could have, potential change in leadership, you know, overseeing Fannie and Freddie. You know, there have been times when the administration has asked Fannie and Freddie to look at principal modifications as a loss mitigation tool.

And the view of their overseer has been that that is not in the economic interest of the two GSEs. Change in leadership there could change that. That can change the dynamics of shadow inventory. And that can have an impact on home prices.

A lot of the prepayments now you've seen in the Agency markets are as a result of borrowers that take advantage of HARP refinancing, you know, HARP refinancing mechanisms, any broadening of eligibility-- there have been things with, you know, in the Boxer bill, you know, which have been implemented, which have increased fees. So any change in policy there is a really big deal.

One source of prepayment friction in the Agency market has been some of the reps and warrant issues surrounding cross-servicer refis. So when Servicer B refis a loan that has heretofore been serviced by Servicer A, the difference in rep and warrant relief when Servicer A refis a loan that they've heretofore serviced, so any changes there could cause prepayment speeds to accelerate. So all those things that can be impacted by leadership changes are definitely things we look at, as well.

I just think that you've gotten pretty consistently on a quarterly basis, for the last two years, significant policy initiatives that have impacted expectations for home prices, impacted the rate at which delinquent borrowers can be transitioned out of their homes, from -- they've impacted Agency prepayment speeds.

So we haven't had a period of stability yet. And we think that there are, you know, definitely more potential changes in the horizon. So that's a source -- it can swing prices around a lot, and it can present opportunities. So we expect that to be -- you know, to be with us going forward.

I guess, you know, after the election, we basically have a -- you know, you have the same president, you get the same breakdown in the House and Senate as to who controls it, so the changes could have been more significant with -- you know, if Romney had won, but that said, you know, you can still get some leadership changes, some of these important groups that control housing policy, that can have big impact on both the dynamics of the housing market, as well as the level of prepayments.

Steven Laws - *Deutsche Bank - Analyst*

Great. Well, it's -- I think everybody's still definitely watching Washington. So it'll be interesting to see as those changes do or don't happen how it is reflected in the market. So thanks for the opportunity to ask questions, and, again, congrats on the great quarter.

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Well, thanks. And thank you for the question.

Operator

Thank you. And our next question is from the line of Ken Bruce with Bank of America Merrill Lynch. Please go ahead.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Thank you. Good morning.

Larry Penn - *Ellington Financial LLC - CEO*

Morning.

Lisa Mumford - *Ellington Financial LLC - CFO*

Morning.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

My first question really is trying to draw out, I think, one of the themes that you had laid out in your prepared remarks. I mean, clearly there has been a significant compression in yield available in the Agency sector, in particular, as I guess everybody is well aware, but it's impacted other sectors, as well.

And if I understand your comments properly, really, one of the things you want to effectively distinguish, you know, with Ellington versus others is that you've got a capacity to generate income that is either dissimilar from others, because it's, you know, specifically related to your ability to be flexible in terms of where you invest, but also because of your ability to trade around different -- you know, different investments from time to time and generate actual income from that.

Is that, you know, effectively one of the key points you want to kind of bring up today?

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Yes.

Larry Penn - *Ellington Financial LLC - CEO*

Yes.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Good. Okay. That was -- just wanted to make sure I got that. I guess I did. So now that we've seen housing fundamentals improve, as you pointed out, in terms of the impact on non-Agencies, are there areas that -- as well as technicals -- as I think Mark pointed out -- you've had this kind of confluence of events that has been so positive.

Are you thinking that some of this is going to reverse and it's all baked into prices at this point? Or how are you looking at the market today in terms of what's going to drive the next move directionally? Is it going to be further improvement in fundamentals? Is it going to be better technicals? What's going to move it from here?

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

I guess what we would say is that, when we look at the current pricing structure of the non-Agency market, we still see tremendous relative value differences among securities that trade on the same day.

So, you know, in a broad brush, you saw increase in asset prices, you know, significantly in the third quarter, but you've seen, you know, increase in asset prices versus second quarter, as well, and we think for a certain subset of securities, it's justified, that they had a sensitivity to home prices that warranted part of their price move. They might have also had a geographic distribution on the underlying loans in the pool that we think dovetailed nicely with our expectations of what parts of the country are going to be the biggest beneficiary of -- further home price gains.

But then we also see some securities that went up in price significantly, where we don't think the move is necessarily warranted. So then our models, if we run those securities, we'll see yields on them that don't -- you know, don't really meet the threshold for committing capital, you know, for the shareholders in this country. And that drives some of our relative value trading decisions, and those are securities that we'll want to prune from the portfolio.

There's also been tremendous, tremendous amount of activity in servicing transfers. When servicing moves from one servicing -- one servicer to another, you can have big changes on -- big changes in the short run on how the cash flows of the securities play out. Some servicers advance delinquent payments more than others. Some servicers are more quick to claw back previous advances than others.

So that's another area where there's been a lot of activity, and we don't think the market necessarily always gets it right. On the impact on a securities price, as a consequence of the servicing transfer, that's another market dynamic that has spurred some of the trading.

So one thing we think has definitely impacted our -- some of our trading this past quarter is we have spent a lot of time and done a lot of work and really digested a lot of data in analyzing, you know, not the home price -- not the housing market from a national level, but to try to drill down into a much more granular level and look at things on a ZIP level.

And when you look at MSAs at a ZIP level of granularity, within one MSA, you can see radically different dynamics within, you know -- for two ZIP codes that are in the same MSA, but the housing market can look, you know, as different as night and day.

And there is a -- you know, not a perfect way to express that in our portfolio construction, because, you know, obviously the deals are backed by, you know, oftentimes many thousands of loans, but there are definitely regional differences in securities of different vintages and securities of different types -- they have prime versus Alt-A -- that we don't think the market necessarily prices in the way we do. So that's one thing that we've been very focused on.

The other thing is that, if you look at prepayment patterns in the non-Agency market, there has been, you know, a response somewhat muted to the drop in mortgage rates. We think that that can play out over time. We think it's certainly possible that the -- sort of the credit box applied to the Agency mortgage market might potentially expand a little bit next year. That can drive some relative value trading. So that's been another area of focus.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

So all that's really just a function of getting -- getting down to the granular analysis within either existing securities and/or specific possible outcomes that will drive value and then, you know, essentially positioning accordingly?

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Yeah, that's right. I would say that our approach to analyzing securities is to try in as -- as greatest detail as we can, understand how the world looks to each and every borrower in terms of their equity position in their home, their prepayment opportunities, what are the dynamics of the housing markets and their zip code, and to try to project the cash flow on a security as the aggregated behavior of the individual borrowers that make up the pool, as opposed to trying to use curve-fitting models.

You know, we'd like to go down to the loan level on everything that we buy or sell. That's been our approach. I think that approach has been really helpful to us, especially when you get into markets where you don't have any historical data.

So you're in a market right now where you don't have historical data on prepayment rates when the mortgage rates are this low, right? You were in a market in 2009 where you didn't have any data on what default rates were going to be when borrowers had the amount of negative equity that they had in their homes.

So our approach has been trying to understand how the world looks to every borrower and what are the incentives to every borrower and then aggregating the collective behavior of the individual borrowers has been a more robust way of projecting cash flows out than just trying to fit historical curves. And, you know, we'll continue to use that approach.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Okay. And my last question is --

Larry Penn - *Ellington Financial LLC - CEO*

Can I just add one more thing?

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Please.

Larry Penn - *Ellington Financial LLC - CEO*

Which is just that -- so I think that, in terms, I think, one of your questions was, do we expect a reversal, you know, on some of these moves? So I think -- so one answer is, we don't expect a reversal, but I just wanted to add that, even without a reversal, there's still a lot of things that go on, and I just want to supplement -- Mark obviously talked about a lot of them -- but one of them I want to talk about just for a second is the synthetic market and the synthetic cash basis and how that moves around.

So if you look at what happened to the ABX indices that we use to hedge a lot, even though, you know, you've seen a fairly steady -- if you look just at the snapshot at the end of each quarter, you know, say, June 30 to Sep 30, it looks pretty stable. You should realize that that actually -- we trade around that a lot during the quarter.

And there are times when -- so, for example, in this rally, at first you had synthetics move a lot and cash was lagging, so that would be a time when, you know, we might start to buy more cash and, you know, then, on the other hand more recently we've seen -- and if you look at the ABX prices, they're still -- you know, I think now back below 60 or in the high 60s. You know, and that's really -- they haven't moved much since the end of the quarter, and even maybe a little bit before then.

And meanwhile, you've got cash prices increasing. So this is something that we're looking at all the time, you know, and -- you know, do we think that -- first of all, are these a good short in their own right, if -- you know, if -- and, second of all, how do they look relative to the cash market?

So, you know, a lot of times we will sell cash and buy back our hedge, and that's kind of a relative value play in its own right. Other times, we might not buy back the hedge. Other times we might add to the hedge, if we think that the synthetic market is getting ahead of itself. So this is another way that we have been very active in this space, and we expect to continue to be.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

And I guess that -- you really, you know, highlights the point that the mortgage market is a very big and diverse market and that gets over-generalized in many ways, and, you know, there's a lot of more detailed trading strategies that can generate value, if you are, in fact, getting your hands dirty, as I like to put it.

Larry Penn - *Ellington Financial LLC - CEO*

Right.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

My last question -- you made a very interesting comment about, you know, the potential for change in leadership at -- you know, within the context of the GSEs and possibly some other legislative initiatives. Is there -- is there something that -- when you look at that, do you have a view as to how that effectively plays out? And are you, you know, expressing that view? Or are you one that thinks it's best to sit on the sidelines and have that effectively occur and then just react to whatever may, you know, come about within Washington?

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

I think -- this is Mark -- so I think you have to construct portfolios that are designed to do well in the current environment, but also to perform well, given changes that, even though you might not think are likely, you think have some reasonable possibility of happening.

So part of our risk management involves around running shocks for different events that can happen, you know, events such as, you know, foreclosure moratoria and extension of, you know, foreclosure timelines and shocks around servicer advances, shocks around home price movements. So we'll run shocks around a lot of things that we don't think are likely, but we certainly think are possible. And we are always focused on how the portfolio behaves under the various shocks.

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, I think one thing, though -- so one of the things, for example, right that DeMarco has been resistant in, is -- and, you know, I assume that part of your question may be directed at, you know, now that Obama's been re-elected, maybe there will be more pressure to replace DeMarco as head of FHFA, you know, since he had been a Republican appointee -- you know, one of the things that he's been very resistant about is principal reduction, right?

And so that's -- you could look at that as a risk, but I think that, you know, I'll just point out that that risk for our non-Agency portfolio, obviously, is not an issue, because this is really related to Agencies. But for Agencies, you know, when you look at the -- the volume that that would create of prepayments relative to all the other prepayment risks that are out there, that particular shock we don't believe is that significant as just general, you know, regular prepayment risk, if you will.

So if you were curious about that particular risk, if there was a new regulator in charge, we don't think that that one is necessarily the one to be most concerned about when it comes to the Agency portfolio.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Which would be? I mean, is it just normal --

Larry Penn - *Ellington Financial LLC - CEO*

I think the expansions to -- expansions to HARP, you know, making it more -- putting servicers on a level playing field versus refinancing their own legacy loans as opposed to other servicers' legacy loans, things like that we think would have a much greater effect on prepayments than principal reduction.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Right, which obviously would be a changing of -- or altering what had been perceived as the rules of the game as of -- you know, as of today, so -- well, that's it. Thank you very much for your commentary and your insights, and I will add to the congratulations on a good quarter. Thank you.

Operator

Thank you. And our next question is from the line of Zach Tanenbaum of MLV and Company. Please go ahead.

Zach Tanenbaum - *MLV & Co. - Analyst*

Thanks. Good morning, everyone.

Larry Penn - *Ellington Financial LLC - CEO*

Morning.

Lisa Mumford - *Ellington Financial LLC - CFO*

Hi, Zach.

Zach Tanenbaum - *MLV & Co. - Analyst*

A lot of what I had was addressed earlier in the call. Just a quick follow-up on your non-Agency portfolio and, really, your assumptions for the housing market -- Lisa, you mentioned there was an upward revision in the assumptions as it relates to the yields on those investments. And, Mark, you went through the technicals and fundamentals.

I'm just curious, kind of going forward, you know, how often you'll revisit those assumptions? Obviously, you're looking at things on a day-to-day basis, but is that something that you'll look at on a -- you know, you'll revisit them on an annual type of run rate?

Lisa Mumford - *Ellington Financial LLC - CFO*

We would look at that, you know, constantly, right? I think that the reason that we decided to make the change was, you know, the improvements in the housing market we saw have been happening over the past several quarters, and we thought it made sense to make the change now. But, you know, we -- it's something that we look at all the time.

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, and I think that we had been using a simpler -- you know, our particular housing model, is -- you know, is obviously complex, varies from region to region in terms of what the prediction is. So in the past, we had been using a more simplified version of that, so I think going forward you'll -- so the change was particularly large this quarter because the deviation between those two -- because now that things have improved, the deviation between the simplified model and the more complicated model was now great enough that we decided it was worth changing to the more complicated models.

So now that we're basically with the more complicated model, you know, we would expect to continue to use that going forward, so I would certainly expect that since we're not changing from one model to the other, we're going to be -- things should be a little more stable, but as Lisa said, something that would have some effect each quarter. But it should be -- I think it should be modest.

Zach Tanenbaum - *MLV & Co. - Analyst*

Thanks. That's helpful. And once more congratulations.

Larry Penn - *Ellington Financial LLC - CEO*

Thank you.

Lisa Mumford - *Ellington Financial LLC - CFO*

Thanks, Zach.

Operator

Thank you. And our next question is from the line of Brad Golding with CRC. Please go ahead.

Brad Golding - *CRC - Analyst*

Hi, guys. Can you hear me OK?

Larry Penn - *Ellington Financial LLC - CEO*

Perfectly. Thanks, Brad. Hey.

Brad Golding - *CRC - Analyst*

I have a couple questions just about the size -- first of all, about the size of the portfolio and the -- I guess you could say the amount of leverage. It really -- the portfolio has increased in size, but certainly not by the amount of the August follow-on. Given that, you know, I guess we're kind of six or seven weeks there, is this an intentional thing to delever the portfolio or was there just kind of a summer lull?

Larry Penn - *Ellington Financial LLC - CEO*

No, I would say that -- so, first of all, if you look at the size of the non-Agency portfolio from one quarter to the next, it's up about $80 million, right, which is actually not that different from how much capital we raised. Now, it doesn't have that half a turn of leverage, you know, that you'd expect.

So I think we -- as of the end of the quarter, as of Sep 30, we deployed about half, okay? And that was a combination of, you could say, spending a little more than half in non-Agency and then decreasing a little bit the capital in Agency. So we -- as of 9/30, we still had, you know, let's just say about half of the proceeds to deploy, which, you know, was in line, maybe a little bit on the slow side, but still in line with the range that we thought in terms of how long it would take to deploy the proceeds.

So -- but, of course, you know, something could happen. We -- you know, we could have deployed it very quickly and -- you know, so -- yeah.

Lisa Mumford - *Ellington Financial LLC - CFO*

I mean, I think we've slowed down a little bit in deployment because of the, you know, tightening of spreads --

Larry Penn - *Ellington Financial LLC - CEO*

Sure.

Lisa Mumford - *Ellington Financial LLC - CFO*

-- you know, over the past several weeks.

Larry Penn - *Ellington Financial LLC - CEO*

That's right.

Lisa Mumford - *Ellington Financial LLC - CFO*

And the Agency portfolio we talked about, right, we purposefully lowered the size of that portfolio, and that's really the driver of our leverage.

Brad Golding - *CRC - Analyst*

Okay. I'm just -- you know, I'm really just looking at the -- you know, the shareholder equity. You know, I for one don't -- you know, never look at when -- when REITs or mortgage finance Agencies talk about capital and capital deployment, because I think it's a little bit confusing for a lot of investors, because everyone has a different model. So --

Larry Penn - *Ellington Financial LLC - CEO*

Right, but what I would say is, what we've always encouraged people to focus on, since it's the main driver of our earnings, is just look at the size of the non-Agency portfolio relative to our capital base. That's, I think -- for me, if you had to look at one number, that's the number I would look at, capital -- sorry, assets in non-Agency MBS to equity capital for the whole thing.

And so it did go down, but only because we -- you know, I would say because we hadn't deployed, you know, a portion of the capital from the offering yet.

Brad Golding - *CRC - Analyst*

So you intend to or have done so?

Larry Penn - *Ellington Financial LLC - CEO*

We would -- well, we always keep, you know, some amount of dry powder in that, but, yeah, other than that, absolutely.

Brad Golding - *CRC - Analyst*

Okay. Then to be honest, that's a little disappointing that it took that long to come out, particularly in up months on, you know -- in -- you know, in the non-Agency mortgage world, to be frank. On that same note, what -- I'm looking at how you're financing, and it appears to be understanding that you've allowed some Agency paper to -- you know, you've reduce your Agency portfolio.

The repo has become much more -- there's a much larger percentage of non-Agency repo at a very high cost.

Larry Penn - *Ellington Financial LLC - CEO*

Right.

Brad Golding - *CRC - Analyst*

That doesn't seem to make any sense to me at all, Larry.

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, no, this is -- so that's a great question. And it's something that we have talked about here. So we believe -- this is just our philosophy -- well, first of all, I would say that it's true that it's higher cost, but it's also a relatively small number, just our amount of non-Agency repo. So the real question for us --

---

Brad Golding - *CRC - Analyst*

(inaudible)

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, let me just finish. So the real question for us, I think, is what you correctly point out is, so we have a dollar of excess cash, and the question is, we want to use it to pay down a repo, which one do we pay down? Do we pay down the higher cost non-Agency or the lower cost Agency?

And absolutely one valid point of view would be, it's obvious, pay down the higher cost repo. It costs more. And I think that's your question, and if I could, you know, just try to answer that question -- or maybe other people are asking that question, too -- so the reason that we do it is that our liquidity management -- we believe that the extra cost of a -- you know, of non-Agency repo versus the Agency repo is worth it in the case that there's some -- even though it's a low probability -- there's some systemic shock that creates a problem in financing non-Agency assets.

Now, I know that, you know, maybe there isn't one that we can see on the horizon, but sometimes you don't always see it on the horizon. So for us, the way that our -- it's really the way that our risk management and liquidity -- liquidity management tools work here, is they enable us to deploy more capital overall if we have more of our repo in non-Agency than in Agency.

So these are systems that we've developed over time, and if we had -- if we had paid down that non-Agency repo, then we would have had less capital to deploy in the types of things that we want to deploy in.

And, you know, I can get into more detail later, in terms of how our -- how that risk tool works, but it's -- that's the way it works. And so we believe that it's better to preserve a certain amount of non-Agency repo, because that's what you need in a case where there's some shock to the system and you want to be in a buy mode. You don't want to be in a hold mode. You'd like to be in a buy mode.

And if we have that non-Agency repo in place already, it's a lot -- through our experience in 2008, it's a lot easier to keep repo on than it is to initiate new repo. So it's really -- it's trying to handle a low-probability event, but for us, that's important.

Brad Golding - *CRC - Analyst*

Okay. To that point -- I understand that completely, that cash is king when the market is in dislocation, right? And I understand when the market's in dislocation, it's tough to get that non-Agency repo, but you're only levered 1 to 1 right now, and it's costing 200 basis points. Is there any way you could go -- you could go -- let me be careful how I word this -- presumably there -- you could go with a 5% or 10% haircut and still be very comfortable on the Agency side.

If it's a matter of maintaining relationships for the broader business, meaning other portfolios are -- have different asset allocations and different mixes in terms of Agency and non-Agency, and this is just a function of one portfolio in a (inaudible) organization, I think you really need to look at that very hard, because the cost is too high.

Larry Penn - *Ellington Financial LLC - CEO*

Yeah. No, look, I think -- like I said, I think it's a valid point. I think that, you know, the amount of non-Agency repo we have, it's not a huge number, but, you know, it's not --

---

Brad Golding - *CRC - Analyst*

(inaudible) Larry --

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, it's not a tiny number. No, no, look --

Brad Golding - *CRC - Analyst*

It's 50% of your assets, so therefore that's 1% drag a year.

Larry Penn - *Ellington Financial LLC - CEO*

Yeah. I agree. And I -- well, a little bit less, but, you know, I agree with you that it is a drag. And, you know, all I can say is that it's -- I think as you can tell, this is not a topic that hasn't been discussed here. It's something that we discuss all the time. And we realize it creates this drag.

But that's -- you know, for us, it gives us more comfort in terms of being able to -- I mean, we're all -- we already -- as you can tell, we are not aggressive in terms of the amount of leverage we use, and we -- you know, if something were to happen, you know, we believe that this will -- you know, this will serve us well. And, yes, it's going to be a drag most of the time, so the optionality of it being there -- if times get tougher -- is just worth a lot to us. It enables us to be more aggressive with the rest of our portfolio. I mean, that's really the point.

We would be -- if we didn't have that, we might not even have the -- we might feel -- I mean, you know, I don't have the numbers in front of me, but we might feel that we actually couldn't be adding any more non-Agency at this point, if we didn't have any of that repo in place. So --

Brad Golding - *CRC - Analyst*

Maybe to go easy on everyone else, we can take this offline, because the more you're explaining this, the less I understand it.

Larry Penn - *Ellington Financial LLC - CEO*

Okay. Yeah, let's do that. That's fair. Let's do that.

Brad Golding - *CRC - Analyst*

On the Agency side, my -- at the end of the quarter, your average, I guess, mark-to-market on your paper was about 108.5. I assume that's even drifted higher, but I know we're not allowed to talk about the previous five weeks for some reason.

But even with call protection here, even with prepay protection, is holding a relatively low coupon security at 109 -- at what point do you say this is silly, there's just too much risk on the other side that rates go up and we're holding a low coupon security at 109 or 110 and decide to trim that back and go into ARMs or something else?

Larry Penn - *Ellington Financial LLC - CEO*

Mark...

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Well, to us, it depends on, you know, what's the cost of hedging it, right? And at the end of the day, after you figure out your cost of hedging, how much is your net margin on those securities, right?

So I think for the Agency market, what we see it is -- you know, you can get maybe 150 basis points NIM over your hedging costs, but your point is exactly why -- you know, when you buy the thing at 109, your biggest risk is your model's wrong and prepayments are faster than you thought.

That's why we keep the big TBA hedge, because (inaudible) you know, by having the TBA hedge, if prepayment expectations come in higher than you anticipate, you know, presumably you're going to make some money on your short, too.

So in deference to what you're saying, that's part of the reason why we have trimmed the holdings a little bit. And it's also why we -- why we keep the TBA short. But that said, you know, it was a very strong quarter for us in the Agency market and we actively traded it. And there's still lots of relative value for specified pools versus TBAs. So that's been a big source of return.

But, yeah, the NIM has definitely come down, but the NIM's not down to zero, right? So I think that if you really search for the best pools that have the attributes you like, you can still capture 150 basis points spread. And it's in from where it was, and there's obviously policy risk to that, so that's why we've -- it's for both those reasons that we're keeping the TBA short, which mitigates some -- a lot of the policy risk, and it's always why we've reduced the capital allocation. Because you're right, I mean, these prices are high on debt that's callable.

Brad Golding - *CRC - Analyst*

Yeah, and obviously there are, you know, Agency REITs out there who are really -- you know, I want to say pushing this as their reason for being. And it scares me.

That -- I assume over the past few days here, the TBA shorts have worked relatively well versus a swap or a Treasury short, given, you know, the conditions in the market.

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Well, it's been really -- you know, right after QE3 was announced, you saw a big lift in Agency securities relative to swaps and Treasuries. But, you know, now we've given up about half those gains, so the TBA shorts are something we've had on for a while. And as long as it looks to us like expected return in the TBA markets are a lot lower than expected returns on specified pools, you know, we'll keep some TBA shorts.

Brad Golding - *CRC - Analyst*

Okay. Thank you. That's it.

Larry Penn - *Ellington Financial LLC - CEO*

Thank you, Brad.

Operator

Thank you. Thank you. Our next question is from Matthew Stolzar with Pyrrho Capital. Please go ahead.

Matthew Stolzar - *Pyrrho Capital - Analyst*

Hi, guys. Was wondering when you expect to release your book value for 10/31?

Larry Penn - *Ellington Financial LLC - CEO*

Yeah, we expect to release that tonight, actually.

Matthew Stolzar - *Pyrrho Capital - Analyst*

Okay, great. Thank you very much.

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Thanks.

Operator

Thank you. And I'm showing there are no further questions. I'd like to turn the call back to Larry Penn for any closing comments.

Larry Penn - *Ellington Financial LLC - CEO*

No, I think we're all set. Thanks very much. And, you know, we look forward to our next call.

Operator

This concludes today's Ellington Financial Third Quarter 2012 Financial Results conference call. You may now disconnect.