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PRESENTATION

Operator

Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the Ellington Financial Second Quarter 2013 Financial Results Conference Call. Today's call is being recorded. (Operator Instructions).

It is now all my pleasure to turn the floor over to Sara Brown, Secretary. You may begin.

Sara Brown - *Ellington Financial LLC - Corporate Counsel, Secretary*

Before we start, I would like to remind everyone that certain statements made during this conference call (including statements concerning future strategies, intentions and plans) 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 such words as "believe," "expect," "anticipate," "estimate," "project," "plan," "should," or similar expressions, or by reference to strategies, plans or intentions.

As described under Item 1A of our annual report on Form 10-K filed on March 15, 2013, 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.

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.

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. I will turn it over to Larry.

Larry Penn - *Ellington Financial LLC - CEO, President*

Thanks, Sara. Once again, it's our pleasure to speak with our shareholders this morning as we release our second-quarter results. As always, we appreciate your taking the time to participate on the call today.

We will follow the same format as we have on previous calls. First, Lisa will run through our financial results. Then Mark will discuss how the MBS market performed over the course of the quarter, how we positioned our portfolio, and what our market outlook is. I will follow Mark, and then we will open the floor to questions.

As a reminder, we have posted a second-quarter earnings conference call presentation to our website, www.ellingtonfinancial.com. You'll find it right on our Shareholders page, or alternatively on the Presentations page of the website. Lisa and Mark's prepared remarks will track the presentation. So, if you have this presentation in front of you, please turn to Page 3 to follow on. I'm going to turn it over to Lisa now.

Lisa Mumford - *Ellington Financial LLC - CFO*

Thank you, Larry, and good morning, everyone. For the second quarter, we generated net income of $11.6 million or $0.49 per share. You can see this on Page 3 of the presentation. Our diluted book value as of the end of June was $24.51, compared to $24.78 as of the end of March, for a very modest decline of 1.1%. And that is, of course, not giving credit to our payment during the quarter of a $0.77 dividend.

In both our non-Agency and Agency strategies, our interest rate hedges offset much of the impact of pricing declines in our investment portfolio, as interest rates sharply increased over the course of the last half of the quarter. Our non-annualized return on equity for the first half of the year, which includes the impact of all mark-to-market adjustments, was 9.4%.

In our predominant non-Agency strategy, we earned $17.7 million of gross P&L for the quarter, or 3% of total average equity for the quarter, non-annualized. This strategy utilized about 80% of our capital during the quarter, and on that basis the quarterly non-annualized return was closer to 4%.

Over the course of the quarter we increased our non-Agency portfolio approximately $189 million on a cost basis. Our average holdings based on amortized costs increased to $584 million in the second quarter, up from average holdings of $514 million in the first quarter, and our weighted average book yield for the second quarter was 8.6%, down from 9.4% in the first quarter.

As of June 30, 2013, net unrealized gains in the portfolio were approximately $58 million, and as measured by value, the bond portfolio was approximately $766 million. The weighted average market yield as of June 30 was 6.8%.

In our Agency strategy we generated a slight loss of $600,000. Our Agency strategy utilized approximately 15% of our capital, and a relatively small loss was notable, again, given the sharp increase in interest rates and the relative underperformance during the quarter of specified Agency pools relative to U.S. Treasuries and interest rate swaps. Our interest rate hedges generated gains of $23.6 million or $1.00 per share, significantly reducing the impact of net realized and unrealized losses of $31.1 million.

We held the size of the Agency portfolio relatively constant as of the end of June compared to the end of March at about $860 million, and as Mark will get into when he reviews the portfolio, our TBA hedges extended in duration as rates rose, and this provided a tremendous benefit. They actually provided over half of the income from our interest rate hedges in this strategy.

The increase in our interest income in this strategy was largely the result of an approximately $1.5 million adjustment to our premium amortization expense, which was made in light of higher interest rates and a corresponding decline in expected prepayments. This increase in interest income is offset in our income statement by a corresponding reduction in net realized and unrealized gains and losses on investments.

Core expenses, which we define as other operating expenses and base management fees but excludes incentive fees, financing costs and other direct investment-related expenses, came in at 2.8% of average equity on an annualized basis and were in line with our expectations.

"Other investment-related expenses" is a new line on our statement of operations, and it includes items such as dividend expense on our short equity positions. We incurred incentive fee expense during the quarter, since on a rolling four-quarter basis, our results were in excess of the return hurdle.

Our overall average cost of funds on Repo increased 9 basis points compared to last quarter. As of the end of June, we increased the relative size and composition of our outstanding Repo as compared to that of March 31. As of the end of June, almost a third of our Repo borrowings were for our non-Agencies whereas at the end of March, this amount was about 25%.

In the aggregate, we increased our leverage ratio a bit to 2.02 to 1.00 as of the end of June, up from 1.86 to 1.00 as of the end of March. In connection with the increase in our leverage ratio in the latter part of the quarter, we increased our cash position for both defensive and offensive reasons. On the defensive side, we wanted to hold more cash in light of the higher market volatility, and on the offensive side, we wanted to be in a position to purchase assets that we found attractive. We continue to find Repo readily available.

In May, we completed a follow-on offering where we raised net new capital of $125.3 million, and the offering was slightly accretive to diluted book value. Proceeds from the offering were principally deployed to our predominant non-Agency strategy.

Finally, our Board of Directors recently declared our second-quarter dividend of $0.77 per share, which will be paid on September 16 to shareholders of record as of August 30. Our dividends are paid quarterly in arrears, and at the end of each year our Board will consider earnings and other factors to determine the amount of a special dividend, if any.

For the first 6 months of the year we earned $51.9 million in net income, and after payment of the second-quarter dividend in September, we will have paid out approximately $40.1 million in total dividends. Based on our closing price yesterday of $22.76, our annualized dividend yield is 13.5%.

I will now turn it over to Mark.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

Thanks, Lisa. So lots to talk about this quarter, and I'm going to be discussing a lot of the headwinds and challenges of the quarter, but I just think it bears repeating that despite these challenges, we made money this quarter. So taken together, the effectiveness of the hedges; the income earned on the portfolio; and the trading opportunities combined to overcome all the challenges.

Slide 10. On a hedge-adjusted basis, non-Agency MBS did okay for the quarter. Now, they didn't do okay every day or every week, and there were times when they had pretty large price drops, but for the non-Agency bonds that we held at the start of the quarter and at the end of the quarter, prices only moved by a small amount, less than 1 point.

Part of that performance was by design of the portfolio. We own mostly floaters or hybrid ARMs that are now past their fixed-rate period. As interest rates moved up, these bonds get priced in the expectations of higher coupons in the future, whereas fixed-rate bonds don't get that benefit. As rates rise, that is the kind of bond many investors want.

This quarter, the way we made most of our money was on interest rate hedges, carry income, and realized gains; and that is a lot different than many of the quarters of last few years. We grew the portfolio. There were periods of great distress in the quarter. There was selling from European banks; funds from Fannie Mae and Freddie Mac; and by the time June rolled around, many other investors weren't in the position or the mindset to commit capital. We grew the portfolio because of our capital rate and the opportunities.

I think this quarter is a good example of our belief that no single strategy works all the time. We have had lots of quarters where we made money because non-Agency prices went up. This quarter we made money because they didn't go down in price but the things we were short -- our hedging possessions -- did go down in price.

Slide 12. Mortgages were front and center of the second-quarter sell offs. Bond redemptions and REIT deleveraging led to a lot of forced selling of MBS. We increased our credit hedges as our portfolio grew in size, and in deference to the strong housing market, most of our hedges are no longer in ABX.

Slide 14, the Agency portfolio. For this quarter I really think it's helpful to think about splitting the 3-month period into two sections. The first part, you had the 10 year note between 1.6% and 2.2%; and for the second part, it was between 2.2% and 2.7%.

In the first period, Agency MBS performed well, recovering much of their first-quarter weakness, and the biggest risk market participants seemed to want to control was pre-paid risk, kindled by some 1.60% prints on the 10 year note. The second part of the quarter was dominated by a violent rate selloff, driven by fears of less accommodative Fed policy.

Here is some context. In the quarter, from peak to trough, Fannie Mae 3s ranged from a price of 104.5 down to 96. That is an 8.5 point range. From the start to the end of the quarter, they dropped 5.75 points. This quarter really highlights the importance of hedging. When you are 9x levered on assets that are moving in an 8.5 range, and you wind up being basically flat, that means you are appropriately hedged.

Even though we wound up basically flat for the quarter, a lot went into that performance. It is instructive to partition the price decline in the Agency pools into three pieces. The first piece is that mortgages underperformed swaps and treasuries. So even if swap yields didn't move at all, the spread widening caused mortgages to go down in price. That underperformance was worth a point or two.

The second and biggest part was the interest rate move. At the start of the quarter 30yr Fannie 3.5s had a duration of about 4 years. The 4-year swap moved about 50 basis points -- it started at about 70 basis points and ended at 120 basis points -- so that rate move on a 4-year duration cost about 2 points.

But the real killer -- and this is why you have to dynamically hedge -- is that as interest rates increased throughout the quarter, the duration of Fannie 3.5's extended from about 4 years to almost 7 years, and by the end of the quarter the 7-year swap yield was 2.15%. So that is 145 basis points higher yield than where the 4-year swap started the quarter.

So that was the triple whammy you want to avoid -- too much interest rate risk; assets on the long end of the curve hedged with swaps on the short end of the curve; and too much spread risk. And this is really the beauty of the TBA hedge -- it gets longer as your asset gets longer and extends on a very steep yield curve, and it also cuts down your spread risk.

So what did we do? The pay-ups we thought were too expensive at the start of the quarter came crashing down and started to look very cheap to us by the end of the quarter. So we sold out a bunch of pools we had bought for low pay-ups and bought a bunch of pools where the pay-ups had dropped materially. And I'm talking 2 point drops in pay-ups, in some cases.

We were active. We took almost $6 million in realized losses. There were pools that had 2 point pay-ups midway through the quarter that we bought for an eighth of a point by the end of the quarter. That is the sort of opportunity volatility and distress create.

Slide 15. The hedges extended when measured by 10 year note equivalents, but most of that happened organically as the TBA shorts extended in duration. We did not have to be in the market hedging interest rate risk or selling assets after prices had already moved by 4 points.

So what is the outlook for Agencies? We think it looks very good. People are quick to forget, but one of the biggest risks in the strategy is pre-pay risk. And now for many coupons that risk is over 100 basis points out-of-the-money, and for other coupons it is very cheap to mitigate by buying pools with favorable characteristics. The spreads to treasuries provided by Agency pools is relatively wide, and over time the fact that refi-generated supply is down significantly and the Fed has shown some tradable floats creates a very good technical.

And with that, I would like to turn the presentation back over to Larry.

Larry Penn - *Ellington Financial LLC - CEO, President*

Thanks, Mark. So the second quarter of 2013 was filled with extreme volatility in both our non-Agency and Agency strategies. But once again, Ellington Financial was able to both capture upside and control the downside, resulting in net income of $11.6 million on a fully mark-to-market basis.

As you know, we have always been extremely disciplined about hedging our interest rate risk. However, since interest rates had done nothing but steadily decline since we launched Ellington Financial in 2007, those interest rate hedges have actually reduced our returns every year until this year.

But that's okay -- we have always felt that our job is not to bet on interest rates, or even passively sit back and let interest rates movements dictate our returns. Instead, we have always felt that our job is to use our expertise and experience in the mortgage market to deliver superior returns over market cycles, and to do that, we have always felt that we needed to be disciplined about hedging most of our interest rate risk.

As our results have shown, our discipline really paid off this past quarter. We have been talking for years about the advantage of being able to hedge our MBS with short TBA positions; about the importance of hedging dynamically as interest rates move; and about the importance of hedging over the entire yield curve as opposed to just hedging the short end of the yield curve.

Over the past few years, while interest rates were declining, our philosophy might have seemed purely theoretical to some. But after this past quarter, I think our results should convince you that this is all extremely real; tangible; and in the end, prudent.

Of course, Ellington Financial's status as a PTP helps a lot. There are virtually no tax-driven or regulatory-driven constraints on our ability to manage our interest rate risk.

So the bottom line is that where many other market participants ended the quarter with significant losses, we at Ellington Financial not only weathered the storm, but we made money. And as a result, we were positioned -- and we remain positioned -- to capitalize on the dislocations caused by the surge in interest rates and sharp decline in prices.

In our non-Agency strategy, thanks in no small part to our interest rate hedging activities, we were actually able to deliver solid returns for the quarter. In the first half of the second quarter, with the US housing market continuing to recover strongly, and with home prices such an important factor in the performance of distressed residential mortgage-backed securities, we saw strong total returns in the non-Agency residential market through May.

However, the strong housing market was also a key factor in the Fed's decision to begin the discussion on QE tapering, sparking the surge in interest rate that roiled the bond markets, and the non-Agency RMBS market was not spared.

As we discussed in our last earnings call, earlier this year we have been taking profits in some of our more distressed, lower-priced non-Agency RMBS, as we felt that they had risen too far in price relative to many of the less distressed, higher-priced non-Agency RMBS, and we continued this rotation in the first part of this past quarter.

However, in the second part of the past quarter, interest rates surged; the Lloyds Bank portfolio hit the market; and the RMBS market dislocated. And as is often the case in times of market distress, many dealers and market participants found themselves under great pressure to reduce their risk, and higher-risk securities in particular now became oversold. When this happened, we actually reversed our previous sector rotation, and so we started to rotate back into certain beaten-down, riskier, lower-price securities that dramatically underperformed in the selloff.

As Lisa mentioned earlier, we have significantly increased our cash positions to be able to take advantage of what we think are excellent opportunities to purchase long-term assets at very favorable prices and yields. Basically, we are positioning ourselves to play offense while many of our peers are stuck playing defense.

Okay, onto our Agency strategy. Now, even though this strategy represents only about 15% of our capital, I'm going to spend a little more time than usual discussing the strategy, since so much happened in the sector during the quarter; and since I believe our performance in the strategy reveals a lot about how we think about managing risk and generating returns, and how we differentiate ourselves from our peers.

In our Agency RMBS strategy, once again Mark Tecotzky and his Agency pool team did an absolutely superb job, and the last part of the quarter was undoubtedly the toughest market for Agency RMBS in years. As you see on our earnings attribution table on Page 3, we only lost around

$600,000 in the strategy during the quarter. This was not only merely a 12 basis point drag on Ellington Financial's ROE for the quarter, but it was also less than a 0.75% loss on the average capital we had deployed in our Agency strategy. I'm sure that I don't have to remind many of you on this call that the typical Agency mortgage REIT dropped around 18% in book value during the second quarter.

As you can see on Page 22 of the presentation, our assets-to-capital ratio in our Agency RMBS strategy has been around 9-to-1 for a while. Now, this past quarter really vindicates what we have been asserting for some time -- that our Agency RMBS strategy, even though we employ an extra turn or so of leverage compared to many others' Agency RMBS strategies, actually has lower risk and offers a "better quality return."

From time to time, we've spoken about the advantages of using TBA short positions to hedge our specified pools. Put simply, the most effective way to hedge mortgage pools is by establishing short positions in other, similar, mortgage pools, such as the generic pools that underlie TBAs.

That is why we always highlight our "net Agency premium" in our earnings releases. TBA short positions help reduce prepayment risk in ways that interest rate swaps just can't, since the mortgages underlying the TBA short hedges are exposed to so many of the same types of non-interest-rate-related prepayment forces, as are our specified pool assets. However, as Mark described, this past quarter highlighted two other extremely important advantages in using TBA short positions.

First, they protect against a widening of the mortgage basis, and by that I mean that if the whole mortgage-backed securities sector is weakening relative to treasuries or interest rate swaps, our book value will be better preserved if we're short TBAs instead of interest rate swaps.

Second, our TBA short positions dynamically hedge our duration in a way that ordinary interest rate swaps don't, and by that I mean that they just naturally extend or contract in duration following an interest rate shock, in much the same fashion as do our specified pool assets that they're hedging. In effect, using TBA short positions to hedge is a very rough form of "match funding."

Now, I don't want to give the impression that our specified pools are always 100% hedged with TBA short positions -- they're not. Depending on how we feel about the absolute value of our specified pools and their relative value when compared to TBAs, we might have a very small or a very large TBA short position.

For example, if you look on Page 15 of the presentation, you will see that for the past two quarter ends, roughly 50% of our hedges have been in TBAs as opposed to in swaps and treasuries. At the end of the fourth quarter of last year, however, our specified pools were roughly 70% hedged with TBAs, since that was when the Agency mortgage sector overall was trading at what we felt were fairly tight levels.

Okay, moving on. On last quarter's earnings call, I mentioned that Ellington Financial was actively evaluating opportunities in the mortgage originations market. Our search to acquire a mortgage originator is progressing nicely, and with many originators struggling in this higher-rate environment where refinancing activity is plummeting, we are seeing some excellent buying opportunities. Our recent hire, Steve Abreu, has been leading our effort. Steve is a highly respected veteran in the mortgage banking business and comes to us most recently from GMAC Mortgage, where he was President. We are really excited to have Steve on board.

In early May, we completed our second follow-on common stock offering since our IPO, resulting in net proceeds of approximately $125 million. From an asset acquisition standpoint, our timing was excellent, and we were able to deploy all of this fresh capital over the remainder of the quarter, taking full advantage of all the opportunities discussed earlier that arose from the severe dislocations.

As you can tell, I fervently believe that this past quarter has further vindicated our strategy, and has further differentiated Ellington Financial from its peer group in a very positive way. Once again, the mortgage market finds itself as the "center of the action" in the fixed-income market. We look forward to taking advantage of what has shaped up to be a great market for us.

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 will be happy to respond to questions to the extent that they are directed to matters related to 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.

Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Steve DeLaney, JMP Securities.

Steve DeLaney - *JMP Securities - Analyst*

Good morning and congratulations, guys, on just a superior job in preserving book value in the second quarter. We thought you would do a good job, but down 1% is remarkable, so great job.

You didn't comment on this, but I thought since it is a recent development, I wanted to ask if you looked at the Freddie Mac risk-sharing offering, and if you had any interest, and if you participated in that?

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

Hey Steve, it is Mark. So we did look at it, and we think it is interesting. We didn't participate, but there's going to be a lot more of those coming down the line -- Fannie is going to be doing one after Labor Day -- I think, though, to us the structure makes a lot of sense for the GSEs to start buying some protection on the credit risk they take, and as opposed to their traditional way of getting protection from MIs, this is a much better diversified pool of capital they can get credit protection from. It came at a time when there was a lot of dislocation in the market, because there were a lot of other assets that had gotten pretty badly beaten up by the time that deal came.

Steve DeLaney - *JMP Securities - Analyst*

Right.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

And also, in terms of how those securities will perform, it's a little bit different than the bread-and-butter securities we've been putting into EFC. So most of what we have in EFC are securities that are the most senior part of the capital structure. This structure had 30 basis points of credit enhancements below one of the bonds and 1.65 basis points of credit enhancement below the other bond, and each tranche was 135 basis points thick.

Steve DeLaney - *JMP Securities - Analyst*

Right.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

So they were very thin slivers. And the valuation process for that has to do with valuating this out of the money put, right? The vintage of collateral they chose to back this performed extremely well, had almost no losses, and it is the kind of thing that suggests -- how big a shock in home prices would you need to start taking losses on these securities?

But given how thin a slice they are, when you start taking losses on these securities, you can get wiped out quickly. So I'd say that from a valuation standpoint, it is different than what we normally deal with, where most of the securities we buy, the amount of write-down they are going to have is going to be basically linear with deal losses. With valuing these securities it is very nonlinear versus deal losses. There's no losses for a while, and then you start taking losses roughly 100 times relative to your tranche size versus the actual loss.

So I think it is something that we will watch and we will definitely analyze. And I could see it having a place in our portfolio in the future; just the first transaction we didn't participate in.

Steve DeLaney - *JMP Securities - Analyst*

Got it. And as you look forward to maybe a Fannie offering or a revised offering, do you think you might play more-- if they do multi-tranche deals -- you might play more at the senior part than at the lower part, given what you said?

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

It all depends on pricing.

Steve DeLaney - *JMP Securities - Analyst*

Okay.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

The other development in the quarter from Fannie and Freddie is they were each sellers of securities. They each have relatively large legacy portfolios.

Steve DeLaney - *JMP Securities - Analyst*

Exactly.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

So as they were selling securities -- and I can't remember if it was the end of the quarter or if it actually took place in July, but they were sellers of securities. That was another area we were able to put capital to work.

Steve DeLaney - *JMP Securities - Analyst*

Good. And my last question --

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

So get the (inaudible) deal.

Steve DeLaney - *JMP Securities - Analyst*

Yes. My last question -- it sounds like if it had been a time when there wasn't good value in the market, you might have gotten involved, but there were too many other attractive things to look at given the dislocations.

Just looking forward, my final question is on the RMBS 2.0 market and your effort in whole loans. So it sounds like there your focus is going to be on new originations and clean paper. I assume prime jumbo rather than either NPLs or re-performing.

Just curious if you guys, working with Steve, if you've been tracking the issuance and the spreads, and if you feel like the market right now -- if you had your platform all up and running, do you feel that with today's primary pricing that you could actually execute transactions in the market that exists today? Thanks.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

Yes. I actually think that where we are going to find things that are more interesting to us will be in the sectors that aren't as pristine. So I don't think it will be in the prime jumbo sector.

Steve DeLaney - *JMP Securities - Analyst*

Oh, okay.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

Because in the prime jumbo sector, you have to compete with the big banks that have -- you know, as good as our funding is, the big banks have better funding. And that is where their appetite really is, especially on the ARM side. So I think it could be in nonperforming, re-performing, potentially some of these HUD auctions.

You know, we haven't bought anything yet, but we have been putting a lot of resources into it. We are tracking it closely. I do think just in the second quarter, when there was so much volatility in regular CUSIPs -- and regular CUSIPs are pretty liquid; you can trade them on a bid list, trading at 1 point or so bid offer. Liquidity, the liquidity premium, the extra yield we'd want for going down in liquid into loans was higher than, say, it would have been in the first quarter, when things were a little bit more stable. That is another thing that we think about.

But I think that you are going to have a lot of supply of loans -- a lot of the big banks have been selling -- and that is a strategy that we have been spending a lot of time on our models, and I think there are going to be times when Ellington Financial will benefit from that effort. But we didn't participate -- we didn't buy anything in the second quarter.

Larry Penn - *Ellington Financial LLC - CEO, President*

Yes, and I just want to differentiate, because I want to manage expectations here, right? You mentioned Steve on the origination platform. So I think that it's way premature to be talking about that, especially in the near term. What Mark is talking about is, our participation could be in the form of buying whole loans, but that is away from any originations subsidiary that we might end up acquiring, or participating in the lower parts of the capital structure in other people's originations and securitizations.

So I just want to make it clear that I think -- I just think it is way premature to be talking about those strategies now, as applied to a mortgage originations subsidiary.

Steve DeLaney - *JMP Securities - Analyst*

Yes, I appreciate that. Definitely appreciate that clarity, because it sounds like, in terms of the whole loan, you're going to look at multiple avenues to get involved, not just building a platform or a conduit; but to be more opportunistic, as well.

Larry Penn - *Ellington Financial LLC - CEO, President*

Absolutely, yes. Go ahead.

Steve DeLaney - *JMP Securities - Analyst*

Okay.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

I was just going to say, one thing you clearly see, and it accelerated in the second quarter, is that Fannie and Freddie are changing, right? They are doing these stacker deals, they are more aggressively selling non-Agency securities, they were selling CMBS securities. And that is going to be opportunity for private capital that understands the mortgage market. How and when exactly it manifests itself, I can't tell you, but given how big their footprint is, that when they step back just a little bit, it creates a lot of opportunity.

Steve DeLaney - *JMP Securities - Analyst*

And we are confident, you guys, whatever opportunities are there, you are probably going to be right all over it. So thanks for the color and, again, great quarter.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

Thanks, Steve.

Operator

Mike Widner, KBW.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Good morning, guys. Let me follow up on some of the comments you made on the Agency segment. In particular, I guess, I'm sort of wrestling with, as you described the TBA, being short TBAs as a hedge instrument. There's a whole bunch of reasons that that can be very effective, and more effective than swaps in many ways.

On the other hand, we hear peers, and we just actually -- you look out there and see what the dollar role opportunity is in the discount for buying forward and so much -- so I just wondered if you could talk a little bit more about that contrast. Certainly, getting a 25 basis point or so effective monthly discount in buying TBAs, that would seemingly work against you in being short TBAs.

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

Yes, that is very true. It's all a question of timing, right? It's all a question of -- I kind of think -- to me, this quarter -- the main thing about it is that you can't be static in your strategies. The strategies have to evolve in relation to the opportunities -- your hedging strategies, what assets you buy -- because the pricing of non-Agency securities, Agency securities is incredibly dynamic. So in this quarter -- given the pricing structure of pools, and TBAs, and swaps, and swaptions -- and you put it all together in this quarter, it made sense to us to have a substantial TBA hedge on specified pools.

Now, mortgages have repriced; TBAs have cheapened a lot. A lot of TBAs now are fully extended in duration versus the forward curve, so being short them doesn't give you as much volatility benefit as they did at the start of the quarter.

So we look at all those things, and we also look at, first and foremost, the roles. And as the Fed has changed the coupon they are buying, it has changed the pricing dynamics of the roles on a lot of coupons. So you are exactly right. There are certain coupons now where being long TBA might be the most effective strategy, a better strategy than owning pools.

But I just think that it's the kind of thing where every day, the world changes a little bit. And you have to try as best you can to look at the world with a fresh pair of eyes each day, and think each day, what is the best risk-adjusted return in the marketplace? And then try to migrate the portfolio there. But you are absolutely right that large roles are a big argument for reducing TBA shorts or being long TBAs.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Thanks, appreciate that. And I guess maybe just more broadly on the Agency piece. For all practical purposes, I would call it roughly breakeven this quarter, which is -- I think for what you guys said -- that's sort of a triumph relative to what might have otherwise been, given the sharp rise in rates.

How should we think about the relative attractiveness of both capital and returns across the Agency versus non-Agencies? Given that for you guys, I think we usually think of the Agency piece as it's there, but it's not what drives the business. But is it more interesting now given the -(inaudible)?

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

I would say that with Ellington Financial, we have traditionally kept at a minimum 80% of our capital in non-Agency strategies, and I think that the returns -- the expected returns -- for both strategies improved over this quarter. Mortgages widened, and you got rid of a lot of prepayment risk.

So if you look at the refi index and metrics like that, it is way, way down. So a lot of securities that had a lot of prepayment risk at the start of the quarter, now that prepayment risk is at least 75 basis points out of the money. But on the non-Agency side, you saw certain sectors cheapen up materially. You have higher rates, higher forward rates, which gives you the expectation of higher coupons on floating-rate securities and hybrid securities. We saw a good amount of distressed selling. We spoke with the GSEs. There are also bank portfolios. And we saw the buyer base step back a little bit in response to the tremendous volatility.

So I think the expected returns for each strategy are up. I also think it's going to come with more volatility. The Fed didn't even do anything -- they just sort of gave people the impression that they were considering doing something -- and that was enough to cause tremendous price volatility. So I think that the opportunities are better, but there's potentially a lot more volatility, too.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

So let me ask you just one final one, then, and I suspect I know the answer to this. But if we run out what your current dividend rate is, it implies a -- if I multiply it by 4 and divide by the book value, I basically get an ROE implication of about 12.5, I believe. So to some degree that is the threshold.

Do you feel better or worse about that, looking forward in the evolution of the market and your opportunities in non-Agencies, and so on and so forth, as we look out into the rest of this year and perhaps going forward?

Larry Penn - *Ellington Financial LLC - CEO, President*

Yes, this is Larry. I think this last quarter really set the stage for us feeling better about it. If you look, as Mark said, the only reason we didn't increase substantially our Agency -- the amount of capital we have in the Agency strategy as opposed to non-Agency-- is that the non-Agency sector weakened as well.

We are able to buy non-Agency securities now. We are back to being able to buy things at close to 9% yield. So that's -- and keep in mind, of course, we've always --as part of how we generate returns -- we keep our leverage lower; we keep our cash positions higher. But a key component of our generating returns is this active portfolio trading that we do.

So given the volatility that we've seen -- and we think that if anything that aspect is better for us in terms of a volatile market -- spreads have widened on Agencies; spreads have widened on non-Agencies. So we feel better about it.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Well, thanks, guys. I appreciate all the comments, and nice job.

Operator

Douglas Harter, Credit Suisse.

Douglas Harter - *Credit Suisse - Analyst*

When you guys look at the credit landscape, can you talk about the relative attractiveness of non-Agency RMBS versus CMBS?

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

If you look at the portfolio composition on Slide 11, on 11 and 12, you can see what we did. So we grew the CMBS a little bit, right? We have -- what's interesting about the CMBS market as opposed to the non-Agency market is the CMBS market, the new issue market is big. It is big relative to the legacy market. So what that means is that you have all these entities that are originating loans and then have to securitize them to get them off their books -- and that process has to happen every quarter--that most of these entities originating these loans don't have the wherewithal to step back from the market and not do securitizations for a couple of quarters if spreads widen out.

It forces the CMBS market to find a level where securities clear. Whereas in a non-Agency RMBS market, if prices drop a lot, you can have sellers just saying, well, I'm just going to wait and not sell until prices recover, and then what happens is you just have wider bid offer spread and not a lot of transaction activity. So all this distress in the market -- that we saw in the non-Agency market -- you definitely saw it in the CMBS market, especially if you look at some of the CMBX indices, like CMBX 6 BBs. These things have been in a 14-point range already this year. So we have found very attractive opportunities in CMBS, and to us they were compelling enough to increase the capital allocation there, and I think you can see that going forward, too.

Larry Penn - *Ellington Financial LLC - CEO, President*

And our approach to that market is different from many. We have taken -- this is not set in stone-- but we've had a pretty barbelled strategy where we've had a portion of the portfolio that we turned over incredibly actively to take advantage of this volatility, some of which is pushed around by the new issue market, but the other part of the strategy has been to identify from time to time much higher-yielding assets. So for example, we have now become known as a significant player in the B-piece market. And those are not trading bonds. Those are holding bonds. And so that is -- we see that position as building up over time. We buy B-pieces sometimes on our own, sometimes in partnership with some of the big servicers. So this is -- we expect over time this to continue, to have this core portfolio growing of very high-yielding assets that we performed a lot of underwriting on, and that we feel good about as a long-term hold; but also to have this very actively turned-over capital in a very different type of strategy that has worked very well for us so far.

Douglas Harter - *Credit Suisse - Analyst*

Great. And then on the Agency side, can you just talk about how you are viewing the hybrid ARM market, and some of the spread widening we've seen there, whether that makes it attractive to you guys?

Mark Tecotzky - *Ellington Financial LLC - Co-CIO*

Well, I would say that we used to own a lot of ARMs. For a while we thought they were very cheap; cheaper than fixed rates. And they are a great -- just a priori, they are great risk asset because they are shorter duration, and they start turning into a floater after certain number of years, they are easier to hedge--But then what happened is, at least, the way we look at the world, was that they got very expensive. It's a logical asset for banks to buy. As banks recovered from 2008, and they were basically funding themselves at zero with deposit, they were the marginal buyer, and it felt like we couldn't really effectively compete with them. We didn't see expected returns on them that to us looked as compelling as the fixed rates, given that for the fixed rates you can put on hedges that are very tightly correlated, and you can run your portfolio as being long volley or long convexity in a way that you can't in the ARMs.

And the thing about the ARMs is they are relatively illiquid. In some ways they are not much more liquid than non-Agencies. There was this big widening. We started to look at them again. We bought just a very small amount.

I would say it's a little frustrating in getting invested in that sector, because they still only represent maybe 3% to 4% of new production in the Agency market, so they are small, but we keep our eye on them. If we can get to our target level, we would definitely buy more. It's just difficult to get invested.

The one thing I am mindful of is that they aren't nearly as liquid. You are going to take -- even though they are shorter rate durations--they are going to have a lot more tracking error versus their hedge than pools versus TBAs. They won't have as much tracking error as fixed-rate pools versus swaps, and I'd say that the risk posturing from the investment banks and how they trade them -- I don't see them wanting to take large positions on them one way or another--which means if you want to move that portfolio around, it can come at the expense of the price execution again.

But they have widened to the point where you think they look attractive; let's say we bought a small amount. We would look to add more, it's just a painful process to be able to get invested in them.

Douglas Harter - *Credit Suisse - Analyst*

Great. Thank you for that color.

Operator

Ken Bruce, Bank of America Merrill Lynch.

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Ken Bruce - *BofA Merrill Lynch - Analyst*

Good morning. The second quarter was probably a pretty good advertisement for your active management strategy, so congratulations on a very good quarter. I'm hoping you might be willing to review your strategy as it relates to the mortgage origination platform that you are looking to acquire or build, I guess looking at Steve. He's been involved with some of the premier Alt-A platforms in the past, and I'm very interested in terms of what you're trying to grow there, if this is a way to generate gain on sale income; if you see this as manufacturing your own securities over time in terms of the non-Agency or non-qualified mortgage arena; what your real strategy is there if you could elaborate on that, please.

Larry Penn - *Ellington Financial LLC - CEO, President*

Sure. So we definitely have -- Steve has and we have -- big plans for this, but we realize that we could start small, and we probably will start small, and grow something. So I think that the reasons that we're getting into this business, aside from being able to partner up with somebody like Steve, is that we want to have all these options -- that many of you just listed -- open to us. So absolutely, if we think that there is a type of mortgage that should be originated but isn't, we absolutely would want to cut out the middleman there and be in that business.

And that, by the way, could apply not just to non-Agency mortgages -- what Mark described before, say non-prime mortgages, so we're not competing directly with the banks -- but also on the Agency side, even, where if we get big enough we could create specified pools, and buy them at cost, essentially. Transfer them up -- essentially transfer them up to the parent, the way that many REITs used to do it in the old days.

So we absolutely are looking at all that. We're also looking at just the business that, if run properly, we think can be very profitable in its own right. Obviously, it's a cyclical business.

But we probably will start small and grow it, but we're looking at all the things you mentioned, looking at securitization; again, not so much for anything that we are going to do anytime real soon. But definitely, as we look at potential businesses to buy, we have an eye towards that, and we say, okay, is this something that we can help build in that direction? So it is really just, at this point, we don't want to rule out any options. We wouldn't want to acquire a platform or build a platform where those things couldn't be possibilities eventually.

Ken Bruce - *BofA Merrill Lynch - Analyst*

And is servicing envisioned to be one of those capabilities and one of those assets that you would be involved in?

Larry Penn - *Ellington Financial LLC - CEO, President*

Yes, I think the answer is that that probably wouldn't be the primary asset, if you will, that we are looking for. I think that obviously when you have an originator, one of the ways that you recognize your profits is by taking back servicing at attractive levels. I think that if we had a small platform without servicing capabilities, in the beginning, that would be fine, too. You can sub-service loans at extremely low cost -- just a handful of basis points, or two handfuls, or whatever -- and you can sub-service, so we would have to achieve, I think, a pretty big scale before we thought about having that be a big portion of why we were in this business. But excess servicing, absolutely; that is an asset that Ellington Financial could acquire now, even, and just for various reasons haven't done it, but there's nothing wrong with the asset class, per se. But primary servicing, I think, is something that would require a much bigger platform. You can outsource it so cheaply to some of the big players.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Right. And then -- just in terms of how you're thinking about the timing around this -- is this something that is a multi-year strategy? You pointed out that it is cyclical -- we are seemingly coming off of a refi cycle, although there's a lot of different contours around that, I think you could argue either direction -- but it seems like there is going to be some uncertainty as to what the volumes are for at least the next few quarters, just with rates having backed up. How are you thinking about the timing of growing this business?

Larry Penn - *Ellington Financial LLC - CEO, President*

Yes, if we start small, then absolutely it will be a multi-year process before we, let's say, would be a top-20 originator or something like that. That would be not something we could develop in just a year, but it's something that we believe we could develop in just -- potentially in 3 years. And so it does depend a little bit on how big we start, and we are looking at different sized players --I don't want to get too specific here -- but we definitely have a long-term view here in terms of -- there are plenty of opportunities, obviously, right now for Ellington Financial to deploy its capital in a lot of these legacy assets and a lot of these burgeoning markets, and this is something -- this is really building for the future. So we are not necessarily in a huge hurry to be there in 6 months.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Great. Thank you for your comments. Appreciate it.

Larry Penn - *Ellington Financial LLC - CEO, President*

Thank you.

Operator

There are no further questions at this time. I would now like to turn the floor back over to Larry Penn for closing remarks.

Larry Penn - *Ellington Financial LLC - CEO, President*

Okay. Well, thanks, everyone for participating on the call today, and enjoy the rest of your summer. And we look forward to speaking with you all next quarter.

Operator

Thank you. Ladies and gentlemen, this concludes Ellington Financial's Second-Quarter 2013 Financial Results Conference Call. Please disconnect your lines at this time, and have a wonderful day.