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EFC - Q1 2012 Ellington Financial LLC Earnings Conference Call

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**Lisa Mumford** *Ellington Financial LLC - CFO*

## CONFERENCE CALL PARTICIPANTS

**Steve DeLaney** *JMP Securities - Analyst*

## PRESENTATION

### Operator

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

(Operator Instructions)

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

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

Good morning, all. Welcome to our first quarter of 2012 Ellington Financial earnings call. I'm Sara Brown, Corporate Counsel of Ellington Financial.

Before we start, I would like to read the following cautionary statement. 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 references 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 described under Item 1A of our Annual Report on Form 10-K filed on March 14, 2012, which can be accessed through the Company's website at [www.ellingtonfinancial.com](http://www.ellingtonfinancial.com), or the SEC's website at [www.sec.gov](http://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 reports the Company files with the SEC, including reports on Forms 10-Q, 10-K and 8-K. We further caution you that the 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.



The presentation also contains more in depth information on our portfolio. To better follow this call it would be very helpful to have the investor presentation with you, which you can access at [www.ellingtonfinancial.com](http://www.ellingtonfinancial.com). With that I'll turn it over to Larry Penn.

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

Thanks, Sara. It's our pleasure to speak with our shareholders this morning as we release our 2012 first quarter results. We all appreciate your taking the time to participate on the call today.

We're coming into this call with a lot of good news, most importantly our strong earnings for the first quarter and a big increase in our dividend. The call will be organized 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 will add some concluding remarks and then we'll open the floor to questions.

To make things as easy as possible for those participating on the call we have slightly enhanced our presentation to track what Lisa and Mark will be discussing in their prepared remarks, so I encourage everyone to turn to page three of the presentation where you will see our earnings attribution table reproduced from our earnings release. And now Lisa and Mark will take you from there through page eight of the presentation. Lisa?

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**Lisa Mumford** - *Ellington Financial LLC - CFO*

Thank you, Larry, and good morning, everyone. As you can see on page three of our quarterly presentation, as Larry just mentioned, we show our quarterly P&L attribution table. There you can see that we earned \$32.1 million for the quarter, which equates to a non-annualized return on equity of 8.4%.

Of the \$32.1 million earned \$28.7 million was from our non-Agency strategy, \$6.3 million from our Agency strategy and we had total non-interest expenses of just under \$3 million. In addition to net carry on our non-Agency portfolio we had realized and unrealized gains as we took advantage of trading opportunities to generate gains, but also recognized valuation increases on the assets held quarter-over-quarter. It was a strong first quarter with a strong quality of earnings.

The average dollar price of our non-Agency portfolio increased a little over 2% to \$57.39 from \$56.11 at the end of 2011, and resulted from two main things. First, as we actively traded the portfolio (and we did actively trade the portfolio -- about 30% turned over during the quarter), we sold securities at gains and reinvested the proceeds in lower-priced securities. Meanwhile, the held securities appreciated on average about 3% to 4% over the period. You can see the March 31 dollar price composition of our long non-Agency portfolio on page 11 of the presentation.

Within our Agency strategy net carry on our assets was also materially augmented by trading gains. Here we also very actively traded the portfolio.

We have found repo financing readily available and our blended cost of financing stayed constant at 78 basis points while our average remaining maturity lengthened out to 43 days from 33 days at year end. During the quarter we added two repo counterparties, bringing total active counterparties to 11. Our leverage ratio came down slightly to 2.33 from 2.42 at year end, but this was more a function of timing of reinvesting, and going forward, we are inclined to modestly increase our leverage as we see opportunities in the marketplace.

Our blended net interest margin was 4.62% for the quarter, reflecting the impact on our portfolios of high yielding assets and low repo borrowing costs.

Expenses came in at 3.1% of average equity on an annualized basis and, all things being equal, we would expect them to remain in the range of 3% to 3.1% for the year. Finally our diluted book value per share was \$23.53 at the end of March, a net increase of 6.8% over December's book value of \$22.03, including the reduction for the fourth quarter dividend of \$0.40 per share that was paid in March.

With that I will turn the presentation over to Mark.



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

Thanks, Lisa. And moving on to slide five, this was a very satisfying quarter because a lot of the portfolio positioning we did in the second half of 2011 helped to generate income this quarter.

Last year we reoriented the portfolio into riskier securities, and we were spending cash when prices were a little lower and a lot of other investors were on the sidelines.

We saw very high loss adjusted yields then and improving fundamentals, but weak technicals. Well the technicals improved materially this quarter. The \$19 billion Maiden Lane II portfolio was well absorbed by the market. There were three separate liquidations, and EFC participated in each of them.

With so much activity in this space we saw lots of relative value opportunities and we traded actively. I think the best news is that to unchanged home prices, and this is on page 11 of our presentation, we still see almost an 11% loss adjusted yield before leverage on our non-Agency portfolio even after the first quarter's strong performance, as much of our return came from capturing the high yield in the portfolio and from trading profits. Right now we see an improving housing market in much of the country and I believe the portfolio is well positioned to take advantage of that.

On to slide six then--if you remember back to last year, credit strategies also performed well during the first quarter of 2011. Back then though we had a much more defensively positioned portfolio.

We see a decidedly different set of risks and opportunities now than a year ago. We put together this chart on page six of the presentation to compare the state of the world then and now.

We are more constructive on the outlook for home prices in much of the country. We think the pricing of securities largely takes into account loan modifications and declining servicer advance rates, and newer vintage subprime and Alt-B securities are significantly lower in price than a year ago.

The cloud of Maiden Lane II that was hanging over the market during the last half of 2011 has lifted. During the sharp pricing correction of the second half of 2011 we lowered the average price of the non-Agency portfolio significantly, going from a weighted average price of 72 at March 31, 2011 down to 57 at the end of this quarter.

So the punch line is that we see both higher yields, a better housing market than a year ago and better technicals.

Slide seven.

The Agency portfolio had another great quarter. We continued to focus on pools with prepayment protection and the portfolio prepaid very slowly in the quarter. There were a lot of trading opportunities we took advantage of, and through our efforts we generated a high return on equity without taking substantial interest rate or prepayment risk, because we don't think you're getting paid enough right now to want to take either one of those risks in substantial size on an outright basis.

Currently we think the Agency mortgage market overall has a lot of prepayment risk, so we have used TBA hedges to reduce our net Agency premium to under 2%. We transitioned much of our portfolio into pools with lower payups, because we think some of the high payup stories have gotten expensive.

Slide eight--market outlook.

So how do we see the opportunity going forward? First we think that non-Agency yields look very compelling. Prices are slightly higher than the end of last year, but fundamentals and technicals have both improved. We view the outlook for home prices better than a year ago.

Some shadow inventory got cleaned up last year. Borrowers that are current on their loans are performing better, and new capital is entering the market to buy REOs or rent it. All these are positives.

For the Agency market, we think the combination of HARP 2.0, the huge profit margins that the mortgage banks are currently earning on refinancing, especially HARP refinancing, and housing policy uncertainty all create substantial prepayments. In response, the cost of many types of prepayment protection has risen sharply-so that's a recipe for risk. If faster overall prepayments don't materialize, the payups on certain pool types may well come down.

If faster overall prepayments do materialize, the payups relative to TBAs may hold up, but the spread to swaps may widen. That's why right now we like lower payup pools and a relatively large TBA hedge. Now I'll turn the call back to Larry.

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

Thanks, Mark. I'd like to conclude by putting the quarter's performance in a slightly larger context. Lisa used the term "quality of earnings," and that's a term that has great importance to us here.

It's one thing to be able to earn high returns by taking big interest rate bets, using large amounts of leverage or having massive exposure to government policy shifts that could create another prepayment wave. That's not what we consider high quality earnings, because while taking these risks might actually pay off a fair proportion of the time, we don't think they will over market cycles, and at EFC we're all about performance over market cycles. When we can generate "trading gains," that is to say taking advantage of short-term mispricings in the market that is a great example of what we consider "high quality earnings" that significantly enhance performance without exposing the Company to significant additional risks.

So even though the Fed has signaled that it will hold short-term rates low for a while, don't we want to avoid just buying 30-year Agency passthroughs that yield less than 3% and not protecting against rising rates, knowing that we might be stuck with that yield for an average life of ten years? If we're concerned that the Agency pool market is priced to perfection and could get crushed should the HARP program get expanded even further, doesn't it make sense for us to hedge aggressively with TBAs and get our net Agency premium down from over six points to under two points?

The last couple of quarters have been incredibly high quality quarters for our Agency strategy and we have generated over \$6 million a quarter on a strategy that only uses about 15% of our total capital. On the non-Agency side, if we can buy non-Agency MBS at double-digit yields to what we consider reasonably conservative scenarios, do we really mind paying a little over 1% on a five-year swap so we can avoid compression of our net interest margin should rates go up?

If the European debt crisis could cause financing of our high-yielding non-Agency RMBS to dry up, doesn't it make sense to keep our leverage low, for example to keep our ratio of total non-Agency RMBS assets to shareholders' equity under one and half to one, so we don't have to sell at distressed prices in a crisis?

Of course we think that the answer to all of these questions is yes.

We've also tended to maintain some credit hedges in place recently, even in the current market where we are constructive on the market. If you turn to page 21 of the presentation, you can see that our credit hedging was critical in preserving shareholder capital during the financial crisis, as well as in 2011 when the non-Agency RMBS markets performed poorly.

We also believe that we can take advantage of significant market mispricings in how we deploy our credit hedges. So from time to time we'll even be able to make money on our credit hedges even while we're making money on our long portfolio. This actually happened in 2009 when our credit hedges made \$10 million even as our long non-Agency portfolio made over \$100 million as you can see in this chart.



And finally, I would like to turn to page 28 of the presentation. This is a slide that many of you have seen for a while. This compares our book value, cumulative book value including cumulative dividends paid, and the progression of that over time compared to this orange line which represents the price of the benchmark ABX 2006-2 AAA, which is representative of the prices of subprime assets.

And as you can see the underlying asset space as typified by the ABX has been extremely volatile over these market cycles, over the past four years. And meanwhile our book value has steadily risen over time. And that's really what we're trying to achieve.

And finally as you know the Company has raised its quarterly dividend to \$0.70, or a rate of \$2.80 per year. The Company set this dividend rate, not only because we feel that the wind is at our back and we expect a great 2012, but also because we think this is a sustainable dividend rate given the excellent opportunities we see in this space.

Of course all dividends remain at the discretion of the board of directors, including whether to declare any special dividends at year end.

This concludes our prepared remarks. Before we open up the call to Q&A I would just like to remind everyone that as usual we'll be happy to respond to your 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.

Also as you probably saw late yesterday we released an estimate of our April month end book value per share. While we're happy to discuss overall market events and trends, 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 March 31, 2012. Operator?

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## 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.

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### Steve DeLaney - JMP Securities - Analyst

Thank you. Good morning, everyone.

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### Larry Penn - Ellington Financial LLC - CEO

Good morning.

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### Steve DeLaney - JMP Securities - Analyst

Congrats on a great start to 2012. Larry, you touched on the board's thinking behind the dividend. I guess I just wanted to pursue that a little bit further so that I have a clear understanding. I'm looking at \$0.70 and I'm looking -- I'm going to look at it two different ways and then ask you to kind of help guide me as to what is most appropriate.

So, well first off the most obvious is that \$0.70 is about a 37% payout on the total earnings of \$1.90, which obviously was an exceptionally strong quarter. So I assume, my first blush is that while it would be nice to make a \$1.90 a quarter that's probably not what you have in your 2012 projection as far as a number we should annualize.

And then the-- I guess the second thing is if we look at the \$0.70 and we do, we annualize that and divide it by your average equity, we get about a 12% ROE. So I guess my question is this. Maybe help us or help me understand sort of why \$0.70 versus say \$0.50, or \$0.60 or \$0.80 given that the earnings in the quarter give you obviously a lot of flexibility. Maybe kind of help us understand what was the thinking behind the \$0.70 level and obviously it appears it's a total -- it's supported by a total return of both carry spread and realized gains as well.

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

Right. Thanks, Steve. So, yes, so it's part science, part art. The science part is that, and as you mentioned that's a little over 12% return on equity, and that's something that we believe--given where we see the opportunity set, not just currently, but looking out further -- that's where we see a quite sustainable level. So that's really the science part.

The art part is that as you mentioned obviously we had a great quarter. We're not expecting to earn \$1.90 every quarter to say the least, but that's a level that -- sure it's only 37% of the earnings this quarter -- but we maintain this flexibility of having a special dividend. So whether it's this year or any other year if we're going to exceed the \$2.80 by a wide margin then we would expect to pay a special dividend. So that way we both have something that we believe looking out further is sustainable based upon the space that we're in and the opportunities that we see, but at the same time it keeps the flexibility of having a special dividend should we underestimate.

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**Steve DeLaney** - *JMP Securities - Analyst*

And on that special, Larry, the possibility of that--that would be based on, what, 100% of GAAP EPS?

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

Well ..no, not necessarily. That's something that we would obviously with the board discuss at the time. I think that it wouldn't necessarily be 100%, so let me just say that. We would however be very sensitive to the fact that if we were to -- now of course we're going to have 100% payout on the first \$2.80 of earnings, right?

That's because we're assuming we're paying the \$0.70 a quarter, so 70 times four is 280, so we've sort of established by doing that a targeted 100% payout on the first \$2.80 of earnings. Now to the extent that we exceed that, one thing we will certainly look at is where is the maximum marginal tax rate. And we're not going to -- we're going to want to well exceed that on our total earnings, right? But to say that it's going to be 100% of our GAAP earnings, I think that's going a little too far. We probably would in many circumstances retain some earnings for a variety of reasons going into say the next year or just in the future.

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**Steve DeLaney** - *JMP Securities - Analyst*

And I guess that will in part be based on how attractive the investment opportunity is for new capital, right?

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

Absolutely.

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**Steve DeLaney** - *JMP Securities - Analyst*

Okay. And just for clarification, a small thing, but your April 30th fully diluted book value I just want to confirm that figure is before the declaration of the \$0.70 first quarter dividend. Is that correct?

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

That's correct, yes. The record date is June 1st, so absolutely.

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**Steve DeLaney** - *JMP Securities - Analyst*

Okay, very good. Well and so thanks for the comments and again congratulations on a good start to the year.

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

Thanks, Steve.

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**Operator**

Thank you. There appears to be no more questions at this time. I would now like to turn the floor back to Larry Penn for any closing comments.

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

No. I think that will do it. Thanks, operator, and thanks, everyone, for joining us this morning.

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**Operator**

Thank you. This concludes today's Ellington Financial first quarter 2012 financial results conference call. You may now disconnect.

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