High-Yield Stocks

Managing Risk in a Changing Financial Marketplace

Specialty finance company adjusts hedging strategy, diversifies portfolio

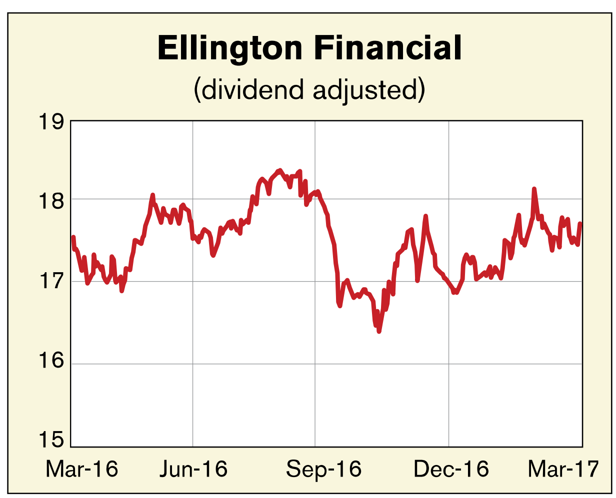
By Elizabeth Blessing

Most would agree it wise to protect oneself against the unexpected. After all, the world is an uncertain place and catastrophes—or, at the very least, unexpected setbacks—can and do happen all the time.

Car insurance protects car owners against financial loss from an accident or theft; hedging gives corporations a sort of insurance against unexpected events or market downturns. Financial hedging, however, is more complicated, and hardly as clear-cut as automobile insurance.

Corporations hedge financial bets to decrease risk exposure, for example, to adverse price movements in an asset held already. In general, they do so by offsetting one position in another investment related to the asset against which they hedge. Of course, offsetting risks comes at a price and corporations that use hedging strategies constantly weigh the risk-return tradeoffs of these efforts.

Such is the case with **Ellington Financial LLC (EFC)**, a specialty finance company and one of our High-Yield Portfolio holdings. For about a decade, Ellington has successfully used credit hedges positioned against credit-sensitive components of its business.



Credit hedging has been a key strategy to decrease potential losses in the company's residential mortgage-backed securities (RMBS) segment. It acquires and manages mortgage-related assets, including both agency and non-agency RMBS. Agency RMBS are guaranteed by a U.S. government agency (such as Fannie Mae or Freddie Mac), but the company also invests in non-agency RMBS without such government guarantees. These securities include Alt-A and subprime mortgage loans, such as gained unwelcome notoriety during the 2008 financial crisis.

To mitigate against the risk their non-agency RMBS segment carries, Ellington used a credit hedging strategy that was quite successful until recently. According to Ellington's CEO, Laurence Penn, "credit hedging was actually the main reason that we outshone the competition in 2007 and 2008." During these turbulent years when many financial institutions posted losses, Ellington's credit hedging strategy gave the company significant gains.

This changed, however, over the past few years as Ellington assets performed well, but credit hedges weighted down overall results. In the first half of 2016, the company's substantive high-yield corporate credit hedges reflected management concerns over vulnerability of credit markets to a variety of potential shocks, including the plunging commodity prices in early 2016 and a then-looming June 2016 Brexit vote. Management did not expect the credit markets to quickly shrug off both events. Markets laughed, however, as heavy central bank intervention averted a credit crisis, Ellington now reports.

To combat poor credit hedging results, in the third and fourth quarters of 2016, management aggressively decreased both its high-yield corporate credit hedge and RMBS portfolios. In early 2016, Ellington's net corporate hedges were worth over $500 million; by December the company had cut net corporate hedges to some $40 million. Similarly, RMBS holdings by late 2016 represented only about 18 percent of the overall credit portfolio, compared to 82 percent in the fourth quarter of 2013.

A new management campaign also sought to diversify the credit portfolio with new or larger stakes in consumer loans, asset-backed securities, commercial loans, commercial mortgage-backed securities (CMBS), and European non-dollar denominated mortgage-backed securities.

For 2016 overall, the company reported a net loss of $16.0 million or $0.48 per share, most of it attributable to the credit hedging strategy used in the first half. After adjusting its hedging strategy and diversification of credit portfolio holdings, Ellington has made steady progress, particularly in performance of its loan portfolios. For the fourth quarter 2016, Ellington reported net income of $1.7 million, or $0.05 per share.

For 2017, with drastically reduced exposure to credit hedges, Ellington management expects to focus more on yield-bearing assets with an increase in allocations to loan businesses. Indeed, the bright spot in Ellington's 2016 annual report was the performance of the loan portfolio. For the fourth quarter 2016, the average market yield for the Ellington loan portfolio was 10.66 percent, up 32 basis points from the third quarter results in that segment.

Ellington CEO Laurence Penn believes there is opportunity in the coming years to continue to increase the yield growth, specifically in the small balance commercial mortgage loan business. Many of these commercial loans (generally under $20 million in size) were originated during the pre-crisis boom and have balloon payments scheduled to hit maturity in the next two years. The field provides ample opportunity for Ellington. According to Penn, nearly $100 billion CMBS loans currently exist, a significant portion of which will have difficulty meeting balloon payments due by 2019. These "small loans are headaches for banks and special servicers," Penn says, but should prove lucrative opportunities for Ellington to add to its loan portfolio.

The company's new 2017 strategies look promising to us and we like the swift action taken by management last year when it became clear the company was on the losing end of its credit hedging strategies. Also, the share price currently appears to be a bargain given the discount to the company's book value. As we go to press, the company trades for $15.60, about 26 percent less than its estimated $19.64 per share book value.

Another good sign is the increased interest of institutional investors in the company; institutions have raised their stake from 49 percent in August 2016 to a recently reported 55 percent. With a healthy dividend yield of 11.4 percent, Ellington Financial remains a recommendation for our high-yield portfolio investors.

Chinese Bank Stocks on the Move

Recently, the improving economic outlook for China has been reflected in surging share prices for China's "Big Four" state-owned commercial banks—the China Construction Bank, Industrial and Commercial Bank of China, Agricultural Bank of China and our high-yield portfolio recommendation, **Bank of China (BACHY)**. Year-to-date share prices have grown 13.5 percent for Bank of China, to levels last seen in August 2015.

Analysts cite the modest monetary tightening strategy of the People's Bank of China (the country's central bank) as one reason for the uptick in bank shares. This coincides with lessening concerns about the level of bad debts at Chinese banks. Credit quality has improved due to debt restructuring among industries with overcapacity. The non-performing loan (NPL) ratio remained essentially flat at a reported 1.76 percent for the third quarter of 2016.

While some analysts question China's encouraging NPL numbers (given China's previous lack of financial transparency), enough investors nevertheless have purchased China bank stocks to drive up share prices. With the bond market plunging amid monetary tightening, Chinese investors now want stable companies with high dividend yields, something the banking segment now provides. Compared to average returns on the Shangai Composite Index of an estimated 1.97 percent, the high average 5.2 percent dividend yield for China's Big Four banks entices investors given the shares' relatively cheap prices.

We believe the upward trend for Chinese banks (and its economy as a whole) will likely continue over the long haul. The Chinese government reported the producer price index (PPI) rose 5.5 percent in December 2016 over that a year earlier, mostly thanks to strong raw material prices. This represents the highest PPI increase in more than 5 years and signals stabilization of China's economy. We continue to recommend Bank of China for its reliable yield—currently 5.3 percent—and its potential gains as the Chinese economy continues to grow. ■