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AGNC - Q4 2019 AGNC Investment Corp Earnings Call

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PRESENTATION

Operator

Good morning, everyone, and welcome to the AGNC Investment Corp. Fourth Quarter 2019 shareholder call. (Operator Instructions) Please also note, today's event is being recorded.

At this time, I'd like to turn the conference call over to Katie Wisecarver in Investor Relations. Ma'am, please go ahead.

Katie R. Wisecarver - *AGNC Investment Corp. - VP of IR*

Thank you, Jamie, and thank you all for joining AGNC Investment Corp.'s Fourth Quarter 2019 Earnings Call. Before we begin, I'd like to review the safe harbor statement.

This conference call and corresponding slide presentation contain statements that, to the extent they are not recitations of historical fact, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

All such forward-looking statements are intended to be subject to the safe harbor protection provided by the Reform Act. Actual outcomes and results could differ materially from those forecast due to the impact of many factors beyond the control of AGNC.

All forward-looking statements included in this presentation are made only as of the date of this presentation and are subject to change without notice.

Certain factors that could cause actual results to differ materially from those contained in the forward-looking statements are included in the Risk Factors section of AGNC's periodic reports filed with the Securities and Exchange Commission. Copies are available on the SEC's website at sec.gov.



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We disclaim any obligation to update our forward-looking statements unless required by law.

An archive of this presentation will be available on our website, and the telephone recording can be accessed through February 13 by dialing (877) 344-7529 or (412) 317-0088, and the conference ID number is 10137880.

To view this slide presentation, turn to our website, agnc.com and click on the Q4 2019 earnings presentation link in the lower right corner, select the webcast option for both slides and audio, or click on the link in the conference call section to view the streaming slide presentation during the call.

Participants on the call include Gary Kain, Chief Executive Officer; Bernie Bell, Senior Vice President and Chief Financial Officer; Chris Kuehl, Executive Vice President; Aaron Pas, Senior Vice President; and Peter Federico, President and Chief Operating Officer.

With that, I'll turn the call over to Gary Kain.

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

Thanks, Katie, and thanks to all of you for your interest in AGNC. We are extremely pleased with AGNC's performance in the fourth quarter as our economic return totaled 9.6%.

This was our strongest quarterly performance in over 5 years. It also brought our full year 2019 economic return to 18.7%.

During the fourth quarter, risk assets performed extremely well with most U.S. equity indices hitting new highs. Credit spreads also tightened during the quarter with many sectors trading at or near multiyear types.

On the interest rate front, the yield curve steepened with the 10-year treasury increasing about 25 basis points to 1.92%.

Swap spreads widened significantly across the curve as the Fed's massive treasury bill purchases and the commensurate improvement in GC repo funding expectations drove a material repricing of government bonds.

Against this backdrop, spreads on agency MBS tightened close to 10 basis points on average with specified collateral continuing to trade well.

While the magnitude of the move was impressive, the strong performance of Agency MBS was completely consistent with the views we discussed on our Q3 Earnings Call.

As we noted on that call, with spreads near multiyear wides, we expected Agency MBS to outperform given the improving funding backdrop.

Importantly, despite the strong fourth quarter performance, we remain optimistic about the prospects for our business as we enter 2020.

Spreads on Agency MBS are close to multiyear averages, while most credit-based fixed income assets are again trading near their tights. Additionally, the FED is likely to remain on hold given the combination of benign inflation and modest global growth.

As a result, the interest rate landscape should be more favorable and likely characterized by lower volatility than what we experienced in 2019.

The coronavirus is clearly a risk to the global economic backdrop in a worst-case scenario, but its impact on interest rates is likely to be both temporary and limited in magnitude.

Lastly, as Peter will discuss shortly, the funding backdrop, a critical component of AGNC's levered investment strategy, should be a material tailwind going forward, a welcome reversal from the headwinds we experienced over the past 18 months.



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2019 was a tremendous year for AGNC, and it reinforces the benefits of best-in-class asset selection and active portfolio management.

For example, the model-based interest rate sensitivity and basis risk tables that we provided at the start of the year would have predicted a very different outcome for our portfolio than what actually occurred, given the sharp rally in rates and the MBS spread widening in 2019.

The sensitivity tables, which assume no intra-year changes to our portfolio, would have predicted a decline in book value of more than 10% based on applying simplifying assumptions of an 85 basis point rally in interest rates and a 10 basis point widening of Agency MBS spreads, inputs that approximate the moves we experienced in swaps and TBAs.

In stark contrast, our book value increased more than 6% in 2019. Two major factors drove the outperformance relative to the model. The first is asset selection and opportunistic changes to our asset portfolio.

Specified collateral, which comprised a large percentage of our portfolio significantly outperformed TBAs, given elevated concerns about prepayment speeds as rates fell.

Additionally, our avoidance of higher coupon TBAs, early in the year, and opportunistic purchases of lower coupons later in the year also boosted our returns.

The second major factor was active management of our hedge portfolio. As interest rates began to rally, we proactively adjusted both the duration and composition of our hedges. These changes, some of which we highlighted on our Second Quarter Earnings Call, had a significant impact on our actual interest rate sensitivity as compared to where we began the year, and explained a lot of the difference between our actual book value gain versus the loss projected by the model.

In summary, we are extremely pleased with AGNC's performance in 2019, especially in light of a less than ideal operating environment. And given our expectations for a relatively benign interest rate environment and more favorable funding conditions, it is hard not to be optimistic about AGNC's future as we enter 2020.

At this point, I'll ask Bernie to review our financial results for both Q4 and the full year of 2019.

Bernice E. Bell - AGNC Investment Corp. - Senior VP & CFO

Thank you, Gary. Turning to Slide 4. We had total comprehensive income of \$1.59 per share for the fourth quarter. Net spread and dollar roll income, excluding catch-up am, was \$0.57 per share maintaining much of the improvement from the third quarter.

The \$0.02 decline for the fourth quarter was primarily due to slightly lower average invested assets and year-end adjustments related to incentive compensation expense.

Looking ahead, the temporary nature of these factors and the improved funding conditions that Peter will discuss should provide a positive tailwind to net spread and dollar roll income over the next couple of quarters.

Tangible net book value increased 6.7% for the quarter as our asset valuation significantly outperformed interest rate hedges, recovering much of the spread widening experienced earlier in the year.

Including dividends, our economic return on tangible common equity for the quarter was 9.6%.

We will report our January month-end net book value in a couple of weeks, but our current estimate is that it is unchanged from year-end.



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Turning to Slide 5. Our investment portfolio increased by \$5.3 billion during the fourth quarter to \$107.9 billion as of the end of the quarter. Despite the increase, our ending leverage was 9.4x tangible equity, down from 9.8x as of September 30, due to the combination of book value appreciation and increase in preferred equity.

Our average leverage was also lower for the quarter at 9.5x compared to 10 point -- compared to 10x for the Third Quarter.

Forecasted CPRs declined to 10.8% from 13.4% during the quarter due to the combination of higher rates and changes in asset composition.

Actual prepayments for the quarter averaged 15.4% compared to 13.5% for the Third Quarter.

Moving to Slide 6. For the year, we had total comprehensive income of \$3.08 per share and \$2.16 of net spread and dollar roll income excluding catch-up am.

And lastly, as Gary mentioned, despite challenging market conditions, we generated an 18.7% economic return for the year.

With that, I'll turn the call over to Chris to discuss the agency market.

Christopher J. Kuehl - AGNC Investment Corp. - EVP of Agency Portfolio Investments

Thanks, Bernie. Let's turn to Slide 7. In contrast with the third quarter, interest rate volatility trended lower in the last 3 months of the year, with intermediate and longer-term rates moving higher during the quarter. More specifically, 10-year treasury yields ended the quarter at 1.92%, up from 1.66% at the end of Q3.

In contrast, 2-year treasury yields fell 5 basis points to 1.57% on the heels of another rate cut by the Fed and improving expectations for government repo stemming from the Fed's bill purchases and other actions to improve liquidity in the funding markets. These same dynamics also pushed swap spreads wider by 8 to 10 basis points.

Risk assets traded well throughout the quarter with Agency MBS performing especially well in the month of December. Higher rates, a steeper curve, expectations for lower interest rate volatility and improvements in the funding markets were all factors that led to the strong performance late in the Fourth Quarter.

Let's now turn to Slide 8. You can see that the investment portfolio increased by approximately \$5 billion to \$108 billion as of year-end. During the quarter, we continued to take advantage of attractive spreads on production coupon, 30-year MBS, while reducing exposure to higher coupon holdings most exposed to prepayment risk.

With the continued outperformance of specified pools, we allowed our spec pool percentage to decline a little and focused our incremental purchases in more generic production coupon MBS.

TBA roll implied financing rates remained weak relative to historical norms versus repo during the Fourth Quarter. However, since year-end, rolls have been trending somewhat better with improvements in other funding markets.

Lastly, on the top right of Slide 8, you can see that our prepayment speed slowed over the last 2 months, given a combination of portfolio repositioning, higher rates and slower seasonal factors for housing activity.

Despite the recent decline in interest rates, we continue to expect prepayment speeds on our portfolio to remain below the peak speed seen last quarter in the absence of a further bond market rally.

I'll now turn the call over to Aaron to discuss the non-agency sector.

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Aaron J. Pas - AGNC Investment Corp. - SVP of Non-Agency Portfolio Investments

Thanks, Chris. Please turn to Slide 9, and I'll provide a quick update on our credit investments. Credit markets exhibited some volatility in spread widening early in the Fourth Quarter, while the Fed was still grappling with repo related issues.

However, as Gary mentioned, credit spreads firmed and ended the year at or close to multiyear types in many cases.

As an example, over the quarter, investment-grade and high-yield CDX indices were and 69 basis points tighter, respectively, both ending the year at the tightest levels we've seen in over 5 years.

This translated into tighter spreads on many of our non-agency holdings. As a result, we continued to shrink our non-agency portfolio marginally.

At quarter end, the portfolio totaled slightly under \$1.6 billion, which translates to between 3% and 4% of equity.

The decline came predominantly in our credit risk transfer portfolio with a focus on 'on the run' paper. CRT has continued to perform well throughout January, even with robust new issue supply. Due to the lag between mortgage originations and CRT issuance, supply in the first half of this year will remain elevated given origination volume in the second half of last year. While the backdrop for residential mortgage credit performance continues to be quite favorable, investments in CRT are becoming less attractive to us in light of the increased supply and material tightening throughout the capital structure over the last several months.

With that, I'll turn the call over to Peter to discuss funding and risk management.

Peter J. Federico - AGNC Investment Corp. - President & COO

Thanks, Aaron. I'll start with our financing summary on Slide 10.

Our weighted average repo funding cost in the fourth quarter declined to 2.12%, down 36 basis points from the prior quarter. This was a big improvement from the Third Quarter, but still higher than it should be given the current Fed funds target.

As we discussed last quarter, our expectation was for repo rates to remain elevated in the Fourth Quarter, but then gradually improve as the market repriced to the additional liquidity provided by the Fed. This liquidity was indeed very significant with the Fed adding close to \$420 billion over year-end through a combination of open market operations and outright treasury bill purchases. And to the Fed's credit, overnight repo at year-end did, in fact, trade very close to the Fed funds target.

The term repo market, however, was more challenging. These rates remained elevated throughout the quarter due mainly to uncertainty about the Fed and how bank regulatory requirements would adversely impact year-end funding rates.

For example, term repo prices implied an overnight funding rate of between 4% and 8% for year-end, substantially above where the term actually traded.

We were reluctant to lock up longer-term funding at these rates, and as such, shortened the weighted average maturity of our funding somewhat in anticipation of better funding opportunities later in the quarter.

As we show on Slide 11, funding levels did improve materially throughout the quarter. In the chart on the top, you can see the gradual improvement that occurred in 3-month repo rates relative to the overnight index swap rate. From its peak in early October, repo rates by this measure improved by about 25 basis points as the Fed added in an increasing amount of liquidity. Importantly, repo rates have remained favorable so far this quarter.



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The chart on the bottom shows 1-month repo rates relative to OIS. This rate was obviously much more volatile given the timing and uncertainty associated with year-end.

The spike in December, for example, corresponds with when 30-day repo first crossed over at year-end. The key takeaway, however, is that 30-day repo has also improved significantly, and is now back to the level of April of last year.

Looking ahead, we expect our funding to improve further over the next couple of quarters and to be a tailwind to our earnings. But that said, the next 6 months will be particularly important for the repo market, as the Fed transitions away from its initial stop gap measures to more permanent measures, which will focus on treasury bill purchases, but may also include a combination of regulatory reform, a permanent repo facility and open market operations as needed.

We are confident this will happen as the Fed has clearly demonstrated its commitment to resolving this repo issue.

Turning to Slide 12. We provide a summary of our hedge portfolio, which totaled \$99 billion, a slight increase from the prior quarter and covered 102% of our funding liabilities.

At quarter end, close to 90% of our swap portfolio was indexed off OIS or SOFR. These swaps, we believe, will better track our actual funding and, therefore, should provide for a more stable aggregate cost of funds over time.

Finally, on Slide 13, we show our duration gap and duration gap sensitivity. Given the increase in longer-term interest rates and our minimal rebalancing activity, our duration gap increased slightly to 0.4 years. With the rally that we've had in January, our duration gap today is now back to flat.

With that, I'll turn the call back over to Gary.

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

Thanks, Peter. And at this point, we'd like to open up the lines to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from Doug Harter from Crédit Suisse.

Douglas Michael Harter - Crédit Suisse AG, Research Division - Director

Just wondering how you're thinking about kind of balancing the portfolio risk between potential refi risk or if this is short-lived and rates kind of snap back? And kind of how you're thinking about the portfolio and hedging in that context?

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

Sure. I mean -- first off, I think from a big picture perspective, as we said in the prepared remarks, we do think 2020, at least up until we'll say the election start to potentially affect financial markets, we do expect interest rates to be kind of to remain in a relatively tight range. That said, we've obviously had this rally in January that's brought us to kind of what we believe is the lower end of that range. But big picture, we don't expect a breakout to the high side, in other words, with ten year rates getting much over 2%. So that's a risk that we're sort of willing to take in the portfolio. And when we make those decisions, we're obviously cognizant of the fact that we're a levered portfolio and we can't make big bets. But the thing



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we usually focus on in these environments to make kind of decisions in terms of how we bias the portfolio is how we expect mortgages, our major asset, to trade in different -- if interest rates move in different directions. And clearly, the risk to mortgage underperformance is biased to a down rate scenario. And for that reason, I think we're definitely more focused on making sure the portfolio is not overhedged into a rally. So that's -- that is our priority amongst these two. And Peter, I don't know if you want to add something?

Peter J. Federico - *AGNC Investment Corp. - President & COO*

Yes, Doug. I would just add to that, in this environment, given where rates are now, is sort of similar to where it was in the third quarter. And although as Gary pointed out, we are worried, obviously, about mortgages in the down rate scenario. We're always cognizant of extension risk in our portfolio. And if you look at our sensitivity table, we actually have a significant amount of extension risk. And so what we've done, like in the Third Quarter and likely, again, given where rates are today, is to opportunistically add potentially more option-based hedges to our mix, even though it is not our base case scenario that rates go up, we obviously want to protect against that move up in rates. And so options tend to be a good choice for us often in environments like this.

Douglas Michael Harter - *Crédit Suisse AG, Research Division - Director*

Great. And then just following up on your commentary that book value is relatively flat. I mean, it looks like Agency spreads have definitely widened this month. I guess, could you just talk kind of about what you're seeing that's kind of led to that kind of better performance in book value?

Gary D. Kain - *AGNC Investment Corp. - CEO, CIO & Director*

Sure. I think it relates somewhat to what you saw this quarter where the performance of our portfolio outperformed, let's say, just TBA spots. And higher coupons and, in particular, higher coupon specified collateral have performed really well year-to-date. And I think that's the biggest driver of maybe the difference in our actual portfolio performance, all right? What I should say is our estimate of our actual portfolio performance, which as Bernie said, is essentially unchanged versus maybe what a generic calculation might kick out.

Operator

Our next question comes from Bose George from KBW.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

I don't know if you mentioned this, but where do spreads currently stand and just the levered ROEs if you're running it at whatever, 9.5 times leverage?

Christopher J. Kuehl - *AGNC Investment Corp. - EVP of Agency Portfolio Investments*

This is Chris. So 30 year 3s or production coupons, as an example, yield around 2.5% with nominal spreads to the swap curve around the 100 basis points or so depending on the prepayment assumption. So using round numbers with 10x leverage that would generate a gross spot ROE of around 12.5% before convexity cost. And specs, as we've talked about, have performed well. And so spreads are a little tighter there. But ROEs are still in the low double digits, but there's a range depending on the category.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay, great. And then just given that backdrop and where you're trading on price to book, can you just give us updated thoughts on capital -- new capital?



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Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

Sure. I mean, as you guys know, in 2019, we did not do a common offering and we -- early in the year, the decision there was based on the fact that we really wanted to avoid higher coupon TBAs, and we talked about that on our First Quarter call. And that was at a time when there was a lot of capital being raised. I think in this environment, some of those concerns are -- have been mitigated. We're comfortable with lower coupon TBAs. That being said, this is an environment where you're going to want to look at the economics. And if there are opportunities for accretive equity, and if we're comfortable with what we can add to the portfolio, and the fact that we can do it within a reasonable amount of time, we're willing to raise equity. But as we said last year, we -- the benefits in terms of raising equity, in terms of our operating efficiency, are still there, but they're definitely lower than they were a couple of years ago given our current size and scale. And so therefore, for us to raise equity, we have to believe that it's accretive to shareholders and make sense kind of just from an economic perspective.

Operator

Our next question comes from Rick Shane from JP Morgan.

Richard Barry Shane - JP Morgan Chase & Co, Research Division - Senior Equity Analyst

First of all, Gary, and I apologize, part of your initial comments got cut off. So I'm not sure you're aware of that. If you guys want to post a transcript, that might be helpful. With that in mind, I was curious if, during that part of the commentary, you provided an update on direction of book value quarter to date.

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

We did provide that. I'm sorry if there were issues with the call. But quarter-to-date, book value is, what Bernie talked about, that is essentially unchanged. That's our best estimate today. Obviously, we haven't run through all of our processes and so forth. But our best estimate is unchanged in response to an earlier question, I think the performance of specified collateral is a big driver of that versus maybe what some of the projections are.

Richard Barry Shane - JP Morgan Chase & Co, Research Division - Senior Equity Analyst

Got it. Okay. I must have missed that in Bernie's comment. Those did come through. That's my fault. Second question, you had talked about not wanting to be overhedged in a down rate environment. And when we look at the hedge ratio, it is approaching as high level as you've been at over the course of the time we've followed you guys. Is the way to bring that hedge ratio down basically at this point to grow the book as opposed to reverse the swaps?

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

So one thing is it's really important not to focus on the hedge ratio, and focus more on the duration of the hedges versus the duration of our assets. Because as we talked a lot about, and it's something that really helped us last year, is even though we were raising our hedge ratio, we were significantly shortening the duration of our hedges. And so the key really around not being overhedged is managing not the number of 1- to 3-year swaps or -- that you have. It's more around longer-term hedges. And that's much more of our focus. We're not -- we -- obviously, the duration gap is a good indicator of that, but it even goes beyond just the duration gap. The thing that will hurt you in terms of book value and in terms of really being overhedged is hedges that are outside of 3 years, and in particular, closer to 10 years. And that's really the area that we're focused on. And by having reduced those positions pretty substantially beginning really in the Second Quarter of last year, I think that, that's our biggest area of protection.



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Peter J. Federico - AGNC Investment Corp. - President & COO

Yes. And Rick, just to round that out, going back to your point about the hedge ratio. If you look at our hedge portfolio, we'll likely have something like about \$10 billion worth of swaps, just a maturity of less than a year. So naturally, if you think about it, that hedge ratio would come down about 10-or-so percent if we did nothing, just allowing to shorter-term hedges to Gary's point just runoff.

Richard Barry Shane - JP Morgan Chase & Co, Research Division - Senior Equity Analyst

Got it. And you won't use -- you won't -- with curve starting to normalize again, you won't be using swaps as -- and forgive this in heartfelt word, but as offensively as you did last year, to generate income.

Peter J. Federico - AGNC Investment Corp. - President & COO

Yes. Well, yes, that's essentially right because what we saw last year is you needed to put on the swaps in order to lock in all of the Fed eases that were being priced into the market. And that turned out to be, at this point, a good trade because the Fed is now -- looks like it's on paused at 3. So as those swaps mature, funding should stabilize. And in essence, you don't have to replace your -- those hedges in order to get the same benefit of, ultimately, our repo rate is going to decline, and it should stabilize down around the Fed effective. So we won't need to replace those in order to take advantage of the funding opportunity.

Operator

Our next question comes from Trevor Cranston from JMP.

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

You guys mentioned a couple of times the tailwind you see to earnings in 2020, particularly on the funding cost side. I guess, when we look back at earnings over the last couple of quarters, they've been substantially higher than they were when you set the \$0.16 dividend level. And I guess, in light of that and the tailwinds you've talked about, can you share any current thoughts you guys have around the dividend level as you look forward into 2020?

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

Yes, sure. I'll be happy to address that. And it's a logical question. And yes, I think you're right. We do expect our net spread and dollar roll income to be substantially above the dividend for the foreseeable future. That said, we don't have any plans to raise the dividend. And the bottom line is we are definitely focused on trying to optimize shareholder returns and maximize them. But we're much less focused on which pocket, in a sense, that money goes. And we actually think it's best to have some retained earnings. And therefore, we have a tailwind to book value as we look ahead. And we think that's the optimal place for shareholders.

Operator

Our next question comes from Brock Vandervliet from UBS.



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Brocker Clinton Vandervliet - *UBS Investment Bank, Research Division - Executive Director & Senior Banks Analyst of Mid Cap*

Obviously, I think you remarked on the coronavirus and the move in the 10-year. Can you just kind of refresh us, Gary, on where the 10-year would need to be, and probably more importantly, where it would need to stick to really change your -- some of your prepay assumptions?

Gary D. Kain - *AGNC Investment Corp. - CEO, CIO & Director*

You know, that's a good question, and it's certainly -- it would have to be probably sub-140 on 10s before we get to kind of -- we get materially lower in terms of mortgage rates than what we saw in September-ish, September, October. So I think big picture, we do have some cushion there. It's not a huge cushion. But on the other hand, we've seen a pretty healthy rally in short -- I mean, in interest rates. And this rally does feel somewhat temporary. So I think big picture, the prepayment picture if we're in the -- we'll call it 1.25-1.30% on 10s does start to get a more dicey. And certainly in heading down there, we would expect mortgages to underperform in terms of price. One thing to keep in mind is this sort of a built-in hedge there as mortgages tend to underperform in price, it obviously negatively impacts book value in the short run. But on the other hand, it actually gives us some protection around the actual cash flows on our mortgages because the prepayment picture is better than it otherwise would be. But that gives you sort of a feel for what we expect. The one other thing I'd add is that unlike, let's say, the first part of the rally last year or, let's say, the second leg -- second or third leg of the rally last year, we've had more time at this point to optimize our portfolio for a low rate environment. And if you look across the board, almost -- essentially all of our higher coupons are prepay protected that have gone through the environment of last year. And then the rest of the portfolio is low coupon brand-new TBAs that are also going to perform reasonably well. And then they are straightforward mitigating strategies to use, such as down in coupon and swapping back into newer mortgages, that we can use to further protect that part of the portfolio. So the other thing to keep in mind is that the portfolio is much more kind of suited for the environment that I just described, if it were to materialize.

Brocker Clinton Vandervliet - *UBS Investment Bank, Research Division - Executive Director & Senior Banks Analyst of Mid Cap*

Got it. Okay. And another big picture question on the GSEs. It's often tough to separate some of the policy suggestions as opposed to what may actually happen. Is there anything that you see coming down the pipe in the next year or so in terms of a structural change or policy change that could affect your business in the GSEs?

Gary D. Kain - *AGNC Investment Corp. - CEO, CIO & Director*

In short, no. There's going to remain noise, but we don't see anything fundamental that's going to change. I guess, the one thing that could change over the next couple of years is that it would be based on kind of what we've heard publicly, I think there's a reasonable chance that REITs get access back to the FHLBs, but no guarantees on that. But that looks like it might be in the cards and not in the near term, but, let's say, over a 2-year period, which would be a benefit. Other than that, I think other changes look like they're going to just be on the margin.

Operator

Our next question comes from Henry Coffey from Wedbush.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Equities Research*

It's great to be back listening to your call, Gary. Great quarter. A couple of issues. Number one, going back to the dividend. Given some dynamic around taxable earnings, is there any specific pressure on the tax side that would either cause you to have to increase the dividend or even allow you to tick it lower?



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Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

So no. I mean, our taxable income for a number of reasons, one of which is dollar rolls and one is accumulated other income losses, is materially below our economic earnings and net spread and dollar roll income. So taxable income, which historically has been a constraint for REITs and kind of forced them to pay these very high dividends and dividends that kind of equal essentially the totality of your potential earnings isn't a problem for us for the foreseeable future. So it does give us a lot of flexibility with respect to where we set the dividend. That being said, as the earlier question related to, we do -- we anticipate that our net spread and dollar roll income and our economic earnings are likely to exceed the current dividend for the foreseeable future. As such, they're really -- that's a comfortable place for the company. And I think we do think about this. And we think about it intellectually. It's nice to have a positive tailwind for book value, and we think that's a good thing for shareholders. So we like the current situation, and we would -- and over time, we'd like to stay in a position where there's a positive tailwind to book value and where we are able to retain some earnings. We do think that that's the right place to be over the long term. But in this environment, it looks like we're going to be able to do that.

Henry Joseph Coffey - Wedbush Securities Inc., Research Division - MD of Equities Research

No, I think that's a great strategy if you're soliciting votes. The other thing is the success of the company is been around your ability to outperform TBAs with specified collateral. Is there anything you can do from an operating perspective, and I don't even know what that would be, to broaden your ability to, in essence, create assets, whether it's on the side of the CRT bonds, which buying them in the open market doesn't look that attractive or somehow partnering with an originator or some sort of flow arrangement? I know you don't want to get too complex on the operating side, but given the importance of that part of the strategy, are there any thoughts you might have on what you could do from an operating perspective to positively impact that side of the business?

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

Well, I think -- look, first off, it's a good question. What I would say is, I think a component of our success or our alpha or our performance relative to the space over the last 10 years has clearly been asset selection. But one thing I would want to say is that asset selection is broader than just specified collateral. I think it starts, and most importantly, with avoiding the worst, which is something we're very good at and where you don't need, let's say, specific access to collateral or unique access to collateral in order to do that. The other area where I think we add alpha and that's helped us over the long run, is around the hedging side of it. So one thing is specified collateral is important. But I'd say, it's a component of that active management that I think has distinguished AGNC. Now with respect to specified collateral -- we -- with respect to kind of moving closer to origination, it is something that we look at. We pay attention to potential opportunities over time. But I think we also have to be practical about our size and scale, which brings significant benefits to the company, both in terms of operating efficiency and in terms of realistically the way the stock trades. And so those kind of strategies have to be really scalable. And that's definitely something that we view as a challenge along those lines. So it's something we'll pay attention to. It's something if there were significant market disruptions that we pay more attention to, but we are comfortable in a sense being an Agency Mortgage Bond investor as we are today, still provides a substantial opportunity to outperform and actively manage the portfolio.

Operator

And our final question today comes from Mark DeVries from Barclays.

Mark C. DeVries - Barclays Bank PLC, Research Division - Director & Senior Research Analyst

Peter, in your prepared comments, you alluded to kind of transition to more permanent measures by the Fed to stabilize liquidity in the repo markets. Could you talk a little bit more about kind of what you expect from those measures? What impact it could have to your repo costs? And what, if anything, you can do to kind of hedge any volatility you might see in those repo costs?



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Peter J. Federico - AGNC Investment Corp. - President & COO

Sure. Thanks for the questions -- good question, Mark. First, I think the Fed deserves a lot of credit for adjusting and adapting over the quarter to the market's needs and really getting control of the repo situation. The challenge in the fourth quarter was that we knew the Fed was taking action. Generally, the market knew that, but it was hard to quantify because the Fed was involving its own position. And ultimately, as I said, by the end of the year, they really had a significant positive impact on the market, but it didn't get fully reflected into term prices. It's starting to get reflected now, and I think the Fed is on the record. And this is the important thing. It's not whether the Fed is going to handle this issue. It's how are they are going to handle this issue. The Chairman's comments yesterday, I think, gave us more confidence about that, right? And I think what the Fed is going to do is transition to, in its permanent measures, using asset purchases as its primary tool, which they were clear about yesterday, buying at least \$60 billion through May and then continuing, importantly, to grow its balance sheet. So I think what the Fed is essentially saying is that you're going to initially address this issue by making the excess reserve so significant in the system that they really won't have to worry too much about the transition mechanism problem, but also willing to do open market operations on an as-needed basis. The two other things that I mentioned, I think, are still on the Fed's agenda, which include potentially regulatory reform and a permanent repo facility. Those two things could have a very significant impact on the transition mechanism, meaning it will make money flow a little easier than it flows today through the Fed's purchases or through its open market operations, but I think the Fed is going to do that. I think the comments yesterday just make it clear that they're committed to doing that in a gradual way and making sure that the markets continue to operate efficiently. And if that's the case, and we believe it's the case, I think you'll see our funding costs come down to a much tighter spread relative to the Fed funds target. I think that's the easiest benchmark to think about for us as the Fed funds target and the natural spread in a sort of stable environment. It's probably closer to 15 or 20 basis points, not 50, like it was in the Fourth Quarter. So that gives you an order of magnitude of where we think the improvement is going to go.

Mark C. DeVries - Barclays Bank PLC, Research Division - Director & Senior Research Analyst

Okay. So it sounds like you don't expect the transition to create any kind of added volatility which could push those spreads back out at all?

Peter J. Federico - AGNC Investment Corp. - President & COO

No, I don't. And in fact, what the Fed has already done is they've already provided a calendar of open market operations through February. So we have certainty around that with overnight and term operations. And as of yesterday, the Chairman committed to open market operations through April now. So we know that they are going to continue to provide liquidity to the system, while they grow their balance sheet, which gives them sort of the permanent injection of liquidity.

Operator

And ladies and gentlemen, with that, we'll conclude today's question-and-answer session. At this time, I'd like to turn the conference call back over to Gary Kain for any closing remarks.

Gary D. Kain - AGNC Investment Corp. - CEO, CIO & Director

I'd like to thank everyone for their interest in AGNC, and we look forward to talking to you next quarter.

Operator

Thank you, everyone. The conference has now concluded. We do thank you for joining today's presentation. You may now disconnect your lines.



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