

CAPSTEAD MORTGAGE CORP

Form 10-Q

November 04, 2016

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-08896

CAPSTEAD MORTGAGE CORPORATION

(Exact name of Registrant as specified in its Charter)

Maryland

(State or other jurisdiction of incorporation or organization)

75-2027937

(I.R.S. Employer Identification No.)

8401 North Central Expressway, Suite 800, Dallas, TX 75225-4404

(Address of principal executive offices)

(Zip Code)

(214) 874-2323

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES

NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock (\$0.01 par value) 95,988,971 as of November 4, 2016

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CAPSTEAD MORTGAGE CORPORATION  
FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2016

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## ITEM 1. FINANCIAL STATEMENTS

## PART I. ¾ FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION  
CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	September 30, 2016 (unaudited)	December 31, 2015
Assets		
Residential mortgage investments (\$13.09 and \$13.54 billion pledged at September 30, 2016 and December 31, 2015, respectively)	\$ 13,582,323	\$ 14,154,737
Cash collateral receivable from interest rate swap counterparties	73,191	50,193
Interest rate swap agreements at fair value	2,501	7,720
Cash and cash equivalents	83,697	54,185
Receivables and other assets	164,102	179,531
	\$ 13,905,814	\$ 14,446,366
Liabilities		
Secured borrowings	\$ 12,431,839	\$ 12,958,394
Interest rate swap agreements at fair value	46,954	26,061
Unsecured borrowings	98,065	97,986
Common stock dividend payable	22,687	25,979
Accounts payable and accrued expenses	36,159	39,622
	12,635,704	13,148,042
Stockholders' equity		
Preferred stock - \$0.10 par value; 100,000 shares authorized: 7.50% Cumulative Redeemable Preferred Stock, Series E, 8,204 and 8,156 shares issued and outstanding (\$205,107 and \$203,902 aggregate liquidation preferences) at September 30, 2016 and December 31, 2015, respectively	198,331	197,172
Common stock - \$0.01 par value; 250,000 shares authorized: 95,989 and 95,825 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	960	958
Paid-in capital	1,296,550	1,310,563
Accumulated deficit	(346,464	) (346,464
Accumulated other comprehensive income	120,733	136,095
	1,270,110	1,298,324
	\$ 13,905,814	\$ 14,446,366

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME(in thousands, except per share amounts)  
(unaudited)

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Interest income:				
Residential mortgage investments	\$49,845	\$49,485	\$162,654	\$158,471
Other	174	88	494	281
	50,019	49,573	163,148	158,752
Interest expense:				
Secured borrowings	(26,636)	(22,272)	(80,232)	(61,584)
Unsecured borrowings	(1,970)	(2,122)	(5,923)	(6,367)
	(28,606)	(24,394)	(86,155)	(67,951)
	21,413	25,179	76,993	90,801
Other revenue (expense):				
Compensation-related expense	(1,299)	(3,064)	(6,565)	(7,573)
Separation of service charge	(2,740)	–	(2,740)	–
Other general and administrative expense	(1,239)	(1,309)	(3,565)	(3,628)
Miscellaneous other revenue	305	261	1,300	368
	(4,973)	(4,112)	(11,570)	(10,833)
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Net income available to common stockholders:				
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Less preferred stock dividends	(3,846)	(3,809)	(11,515)	(11,339)
	\$12,594	\$17,258	\$53,908	\$68,629
Net income per common share:				
Basic and diluted	\$0.13	\$0.18	\$0.56	\$0.72
Weighted average common shares outstanding:				
Basic	95,678	95,530	95,647	95,500
Diluted	95,866	95,721	95,799	95,695
Cash dividends declared per share:				
Common	\$0.23	\$0.26	\$0.72	\$0.88
Series E preferred	0.47	0.47	1.41	1.41

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands, unaudited)

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Other comprehensive income (loss)				
Amounts related to available-for-sale securities:				
Change in net unrealized gains	(19,155)	(11,130)	10,245	(23,770)
Amounts related to cash flow hedges:				
Change in net unrealized losses	12,558	(21,235)	(41,714)	(36,226)
Reclassification adjustment for amounts included in net income	4,927	7,183	16,107	20,494
	(1,670 )	(25,182)	(15,362)	(39,502)
Comprehensive income (loss)	\$14,770	\$(4,115 )	\$50,061	\$40,466

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Nine Months Ended September 30	
	2016	2015
Operating activities:		
Net income	\$ 65,423	\$ 79,968
Noncash items:		
Amortization of investment premiums	95,139	92,458
Amortization of equity-based awards	1,241	1,708
Other depreciation and amortization	97	100
Change in measureable hedge ineffectiveness related to interest rate swap agreements designated as cash flow hedges	506	130
Net change in receivables, other assets, accounts payable and accrued expenses	(953 )	6,389
Net cash provided by operating activities	161,453	180,753
Investing activities:		
Purchases of residential mortgage investments	(2,319,819 )	(2,757,199 )
Interest receivable acquired with the purchase of residential mortgage investments	(3,139 )	(4,202 )
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	2,773,344	2,577,985
Decrease (increase) in lending counterparty investments	50,000	(46,002 )
Net cash provided by (used in) investing activities	500,386	(229,418 )
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	94,430,910	84,927,006
Principal payments on repurchase arrangements and similar borrowings	(92,332,463 )	(87,281,325 )
Proceeds from other secured borrowings	1,175,000	2,450,000
Principal payments on other secured borrowings	(3,800,000 )	(150,000 )
Increase in cash collateral receivable from interest rate swap counterparties	(22,998 )	(12,729 )
Proceeds from issuance of preferred shares	1,167	12,679
Other capital stock transactions	(57 )	(429 )
Dividends paid	(83,886 )	(103,561 )
Net cash used in financing activities	(632,327 )	(158,359 )
Net change in cash and cash equivalents	29,512	(207,024 )
Cash and cash equivalents at beginning of period	54,185	307,526
Cash and cash equivalents at end of period	\$ 83,697	\$ 100,502

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2016  
(unaudited)

NOTE 1 ¾ BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a “REIT”) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as “Capstead” or the “Company.” Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (“ARM”) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae, Freddie Mac, or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae are referred to as “Agency Securities” and are considered to have limited, if any, credit risk.

NOTE 2 ¾ BASIS OF PRESENTATION

Interim Financial Reporting

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2016. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2015.

Recent Accounting Pronouncements

In November 2014 the Financial Accounting Standards Board issued ASU 2014-16, Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity (“ASU 2014-16”). ASU 2014-16 provides guidance in evaluating whether the nature of the host contract is more debt-like or equity-like when determining whether derivative financial instruments embedded in the hybrid financial instrument, such as call rights and conversion features, should be bifurcated and accounted for separately. The Company adopted ASU 2014-16 on January 1, 2016. The provisions of this ASU had no effect on the Company’s results of operations, financial condition, or cash flows.

NOTE 3 ¾ SEPARATION OF SERVICE CHARGE

Effective July 14, 2016, Mr. Andrew F. Jacobs resigned as a director of Capstead and from his positions as President and Chief Executive Officer (“CEO”). Pursuant to an agreement entered into with Mr. Jacobs, he is entitled to payments aggregating \$2.3 million in addition to continuing to participate in the Company’s short- and long-term incentive compensation and employee benefit programs through year-end. Currently estimated costs associated with Mr. Jacobs’ resignation, net of equity award cost accrual reversals, are recorded in Separation of service charge for the quarter ended September 30, 2016. Currently estimated amounts payable to Mr. Jacobs totaling \$2.8 million are included in Accounts payable and accrued expenses.





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## NOTE 4 ¾ NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting dividends paid or accrued on preferred stock and allocating earnings to equity awards deemed to be participating securities pursuant to the two-class method, by the average number of shares of common stock outstanding, calculated excluding unvested stock awards. Participating securities include unvested equity awards that contain non-forfeitable rights to dividends prior to vesting.

Diluted net income per common share is computed by dividing the numerator used to compute basic net income per common share by the denominator used to compute basic net income per common share, further adjusted for the dilutive effect, if any, of equity awards and shares of preferred stock when and if convertible into shares of common stock. Shares of the Company's 7.50% Series E Cumulative Redeemable Preferred Stock are contingently convertible into shares of common stock only upon the occurrence of a change in control and therefore are not considered dilutive securities absent such an occurrence. Any unvested equity awards that are deemed participating securities are included in the calculation of diluted net income per common share, if dilutive, under either the two-class method or the treasury stock method, depending upon which method produces the more dilutive result. Components of the computation of basic and diluted net income per common share were as follows for the indicated periods (dollars in thousands, except per share amounts):

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Preferred stock dividends	(3,846 )	(3,809 )	(11,515 )	(11,339 )
Earnings participation of unvested equity awards	(40 )	(28 )	(123 )	(95 )
	\$12,554	\$17,230	\$53,785	\$68,534
Denominator for basic net income per common share:				
Average number of shares of common stock outstanding	95,978	95,814	95,946	95,814
Average unvested stock awards outstanding	(300 )	(284 )	(299 )	(314 )
	95,678	95,530	95,647	95,500
	\$0.13	\$0.18	\$0.56	\$0.72
Diluted net income per common share				
Numerator for diluted net income per common share:				
Numerator for basic net income per common share	\$12,554	\$17,230	\$53,785	\$68,534
Denominator for diluted net income per common share:				
Denominator for basic net income per common share	95,678	95,530	95,647	95,500
Net effect of dilutive equity awards	188	191	152	195
	95,866	95,721	95,799	95,695
	\$0.13	\$0.18	\$0.56	\$0.72

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## NOTE 5 ¾ RESIDENTIAL MORTGAGE INVESTMENTS

Residential mortgage investments classified by collateral type and interest rate characteristics as of the indicated dates were as follows (dollars in thousands):

	Unpaid Principal Balance	Investment Premiums	Amortized Cost Basis	Carrying Amount <sup>(a)</sup>	Net WAC <sup>(b)</sup>	Average Yield <sup>(b)</sup>		
September 30, 2016								
Agency Securities:								
Fannie Mae/Freddie Mac:								
Fixed-rate	\$416	\$ 1	\$417	\$417	6.68	%	6.50	%
ARMs	10,030,859	319,319	10,350,178	10,506,371	2.69		1.56	
Ginnie Mae ARMs	2,964,263	98,330	3,062,593	3,071,174	2.55		1.16	
	12,995,538	417,650	13,413,188	13,577,962	2.66		1.46	
Residential mortgage loans:								
Fixed-rate	761	–	761	761	6.73		4.09	
ARMs	1,904	9	1,913	1,913	3.80		2.97	
	2,665	9	2,674	2,674	4.63		3.29	
Collateral for structured financings	1,659	28	1,687	1,687	8.16		7.59	
	\$12,999,862	\$ 417,687	\$13,417,549	\$13,582,323	2.66		1.46	
December 31, 2015								
Agency Securities:								
Fannie Mae/Freddie Mac:								
Fixed-rate	\$796	\$ 2	\$798	\$799	6.61	%	6.17	%
ARMs	10,014,401	317,545	10,331,946	10,487,785	2.55		1.68	
Ginnie Mae ARMs	3,542,541	119,225	3,661,766	3,660,455	2.61		1.49	
	13,557,738	436,772	13,994,510	14,149,039	2.57		1.63	
Residential mortgage loans:								
Fixed-rate	1,155	1	1,156	1,156	6.76		5.02	
ARMs	2,650	11	2,661	2,661	3.73		3.15	
	3,805	12	3,817	3,817	4.65		3.71	
Collateral for structured financings	1,850	31	1,881	1,881	8.12		7.82	
	\$13,563,393	\$ 436,815	\$14,000,208	\$14,154,737	2.57		1.63	

(a) Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale.

Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments net of servicing and other fees as of the indicated balance sheet date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans

(b) underlying these investments. Average yield is presented for the quarter then ended, and is based on the cash component of interest income expressed as a percentage calculated on an annualized basis on average amortized cost basis (the “cash yield”) less the effects of amortizing investment premiums. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments.

Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by Fannie Mae and Freddie Mac, which are federally chartered corporations, or Ginnie Mae, which is an agency of the federal government. Residential mortgage loans held by Capstead were originated prior to 1995 when the Company operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities that are backed by loans obtained through

this mortgage conduit and are pledged to secure repayment of related structured financings. Credit risk for these securities is borne by the related bondholders. The maturity of Residential mortgage investments is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 288 months.

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Fixed-rate investments consist of residential mortgage loans and Agency Securities backed by residential mortgage loans with fixed rates of interest. Adjustable-rate investments generally are ARM Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities typically either (i) adjust annually based on specified margins over the one-year London interbank offered rate (“LIBOR”) or the one-year Constant Maturity U.S. Treasury Note Rate (“CMT”), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

Capstead classifies its ARM investments based on average number of months until coupon reset (“months to roll”). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk. Current-reset ARM investments have months to roll of less than 18 months while longer-to-reset ARM investments have months to roll of 18 months or greater. As of September 30, 2016, the average months to roll for the Company’s \$7.63 billion (amortized cost basis) in current-reset ARM investments was 6.2 months while the average months to roll for the Company’s \$5.78 billion (amortized cost basis) in longer-to-reset ARM investments was 42.1 months.

## NOTE 6 ¾ SECURED BORROWINGS

Capstead pledges its Residential mortgage investments as collateral for secured borrowings primarily in the form of repurchase arrangements with commercial banks and other financial institutions. In August 2015 the Company began supplementing its borrowings under repurchase arrangements with advances from the Federal Home Loan Bank (“FHLB”) of Cincinnati (collectively referred to as “counterparties” or “lending counterparties”). Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of each repurchase arrangement and receives the related principal and interest payments. FHLB advances differ from repurchase arrangements in that Capstead pledges collateral to the bank to secure each such advance rather than transferring ownership of the pledged collateral to the bank and simultaneously agreeing to repurchase the transferred assets at a future date. On January 12, 2016 the FHLB system regulator finalized rules originally proposed in 2014 that generally preclude captive insurers from remaining members beyond February 19, 2017 with transition rules that require outstanding advances to be repaid upon maturity or by that date. In response to this action, the Company has reduced outstanding FHLB advances to \$250 million as of September 30, 2016 and anticipates migrating remaining balances away from the FHLB in November 2016. FHLB stock held by the Company in connection with advance activity was reduced by \$20.0 million and \$50.0 million during the quarter and nine months ended September 30, 2016, respectively, with the remaining \$10.0 million held at September 30, 2016 expected to be redeemed by December 31, 2016.

The terms and conditions of secured borrowings are negotiated on a transaction-by-transaction basis when each such borrowing is initiated or renewed. The amount borrowed is generally equal to the fair value of the securities pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a “haircut.” Interest rates are generally fixed based on prevailing rates corresponding to the terms of the borrowings. Interest may be paid monthly or at the termination of a borrowing at which time the Company may enter into a new borrowing at prevailing haircuts and rates with the same lending counterparty or repay that counterparty and negotiate financing with a different lending counterparty. None of the Company’s lending counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security pay-down factors, lending counterparties typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin

accounts with the counterparties in order to re-establish the agreed-upon collateral requirements. These actions are referred to as margin calls. Conversely, in response to increases in fair value of pledged securities, the Company routinely margin calls its lending counterparties in order to have previously pledged collateral returned.

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Secured borrowings (and related pledged collateral, including accrued interest receivable), classified by collateral type and remaining maturities, and related weighted average borrowing rates as of the indicated dates were as follows (dollars in thousands):

Collateral Type	Collateral Carrying Amount	Accrued Interest Receivable	Borrowings Outstanding	Average Borrowing Rates	
September 30, 2016					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	\$ 11,302,826	\$ 24,045	\$ 10,741,746	0.71	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	1,365,926	2,881	1,299,305	0.72	
Agency Securities (greater than 90 days)	160,250	1,003	139,101	0.92	
Similar borrowings:					
Collateral for structured financings	1,687	–	1,687	8.16	
	12,830,689	27,929	12,181,839		
FHLB advances	259,367	1,039	250,000	0.71	
	\$ 13,090,056	\$ 28,968	\$ 12,431,839	0.72	
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (Derivatives) held as cash flow hedges				0.86	
December 31, 2015					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	\$ 9,080,363	\$ 18,504	\$ 8,585,336	0.67	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	423,710	861	346,177	0.63	
Agency Securities (greater than 90 days)	1,073,254	2,519	1,150,000	0.75	
Similar borrowings:					
Collateral for structured financings	1,881	–	1,881	8.12	
	10,579,208	21,884	10,083,394		
FHLB advances	2,956,908	11,422	2,875,000	0.43	
	\$ 13,536,116	\$ 33,306	\$ 12,958,394	0.62	
Year-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				0.85	

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Average secured borrowings outstanding during the indicated periods differed from respective ending balances primarily due to changes in portfolio levels and differences in the timing of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

	Quarter Ended			
	September 30, 2016		December 31, 2015	
	Average Borrowings	Average Rate	Average Borrowings	Average Rate
Average borrowings and rates adjusted for the effects of related Derivatives held as cash flow hedges for the indicated periods	\$12,731,035	0.84 %	\$13,160,703	0.73 %

**NOTE 7 ¾ USE OF DERIVATIVES, OFFSETTING DISCLOSURES AND CHANGES IN OTHER COMPREHENSIVE INCOME BY COMPONENT**

In addition to entering into longer-maturity secured borrowings when available at attractive rates and terms, Capstead attempts to mitigate exposure to higher interest rates by entering into currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate of current and forecasted 30- to 90-day secured borrowings. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements offset a significant portion of the interest accruing on the designated borrowings, leaving the fixed-rate swap payments as the Company's effective borrowing rate, subject to certain adjustments. These adjustments include differences between variable-rate payments received on the swap agreements and related unhedged borrowing rates as well as the effects of measured hedge ineffectiveness. Additionally, changes in fair value of these Derivatives tend to partially offset opposing changes in fair value of the Company's residential mortgage investments that can occur in response to changes in market interest rates.

During the quarter and nine months ended September 30, 2016 Capstead entered into swap agreements with notional amounts of \$500 million and \$2.95 billion requiring fixed-rate interest payments averaging 0.84% and 0.76% for two and three-year periods commencing on various dates between January and September 2016. Also during the quarter and nine months ended September 30, 2016, \$700 million and \$3.50 billion notional amount of swaps requiring fixed-rate interest payments averaging 0.56% and 0.51% matured. At September 30, 2016, the Company's portfolio financing-related swap positions had the following characteristics (dollars in thousands):

Period of Contract Expiration	Notional Amount	Average Fixed-Rate Payment Requirement
Fourth quarter 2016 (expired October 1, 2016)	\$800,000	0.66 %
First quarter 2017	1,000,000	0.72
Second quarter 2017	900,000	0.74
Third quarter 2017	400,000	0.74
Fourth quarter 2017	1,500,000	0.79
First quarter 2018	1,700,000	0.76
Second quarter 2018	600,000	0.79
Third quarter 2018	400,000	0.88
Second quarter 2019	450,000	0.77
Third quarter 2019	100,000	0.68
	\$7,850,000	



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In 2010 the Company entered into forward-starting, three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements with notional amounts totaling \$100 million and average fixed rates of 4.09% with 20-year payment terms coinciding with the floating-rate terms of the Company's Unsecured borrowings. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate associated with the floating-rate terms of these long-term borrowings.

Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820). In determining fair value estimates for these Derivatives, Capstead utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted future variable cash receipts which are based on expected future interest rates derived from observable market interest rate curves. The related net interest payable at the balance sheet date is recorded separately. The Company also incorporates both its own nonperformance risk and its counterparties' nonperformance risk in determining fair value. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation. The following tables include fair value and other related disclosures regarding all Derivatives held as of and for the indicated periods (in thousands):

	Balance Sheet Location	September 30 2016	December 31 2015
Balance sheet-related			
Swap agreements in a gain position (an asset) related to Secured borrowings	(a)	\$ 2,501	\$ 7,720
Swap agreements in a loss position (a liability) related to:			
Secured borrowings	(a)	(5,981 )	(1,051 )
Unsecured borrowings	(a)	(40,973 )	(25,010 )
Related net interest payable	(b)	(11,727 )	(10,942 )
		\$ (56,180 )	\$ (29,283 )

The fair value of Derivatives with unrealized gains are aggregated and recorded as an asset on the face of the Balance Sheets separately from the fair value of Derivatives with unrealized losses that are recorded as a liability.

(a) The amount of net unrealized losses scheduled to be recognized in the Statements of Income over the next twelve months primarily in the form of fixed-rate swap payments in excess of current market rates totaled \$8.8 million at September 30, 2016.

(b) Included in "Accounts payable and accrued expenses" on the face of the Balance Sheets.

	Location of Gain or (Loss) Recognized		Net	
	Quarter Ended in	Quarter Ended	Nine Months Ended	Nine Months Ended
	September 30	September 30	September 30	September 30
	2016	2015	2016	2015
Income statement-related				
Components of effect on interest expense:				
Amount of loss reclassified from Accumulated other comprehensive income related to the effective portion of active positions	\$ (4,927 )	\$ (7,183 )	\$ (16,107 )	\$ (20,494 )

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Amount of gain (loss) recognized (ineffective portion)		(323 )	(336 )	(1,210 )	(642 )
Increase in interest expense and decrease in Net income as a result of the use of Derivatives	*	\$(5,250 )	\$(7,519 )	\$(17,317 )	\$(21,136 )
Other comprehensive income-related					
Amount of gain (loss) recognized in Other comprehensive income (loss) (effective portion)		\$12,558	\$(21,235)	\$(41,714)	\$(36,226)

\*Included in "Interest expense: Secured borrowings" on the face of the Statements of Income.

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Capstead's swap agreements and borrowings under repurchase arrangements are subject to master netting arrangements in the event of default on, or termination of, any one contract. See NOTE 6 for more information on the Company's use of secured borrowings. The following tables provide disclosures concerning offsetting of financial liabilities and Derivatives as of the indicated dates (in thousands):

	Offsetting of Derivative Assets			Gross Amounts Not Offset in the Balance Sheet <sup>(a)</sup>		
	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet	Financial Instruments	Cash Collateral Received	Net Amount
September 30, 2016						
Counterparty 4	\$1,126	\$ 1,375	\$ 2,501	\$ (2,501 )	\$ -	\$ -
December 31, 2015						
Counterparty 2	\$-	\$ 23	\$ 23	\$ (23 )	\$ -	\$ -
Counterparty 4	4,758	2,939	7,697	(7,697 )	-	-
	\$4,758	\$ 2,962	\$ 7,720	\$ (7,720 )	\$ -	\$ -
	Offsetting of Financial Liabilities and Derivative Liabilities					
	Gross Amounts of Recognized Liabilities <sup>(b)</sup>	Gross Amounts Offset in the Balance Sheet	Net Amounts of Liabilities Presented in the Balance Sheet <sup>(a)</sup>	Financial Instruments	Cash Collateral Pledged	Net Amount
September 30, 2016						
Derivatives by counterparty:						
Counterparty 1	\$42,029	\$ -	\$ 42,029	\$-	\$(42,029 )	\$ -
Counterparty 4	15,277	1,375	16,652	(2,501 )	(14,151 )	-
	57,306	1,375	58,681	(2,501 )	(56,180 )	-
Borrowings under repurchase arrangements	12,186,583	-	12,186,583	(12,186,583 )	-	-
	\$12,243,889	\$ 1,375	\$ 12,245,264	\$(12,189,084 )	\$(56,180 )	\$ -
December 31, 2015						
Derivatives by counterparty:						
Counterparty 1	\$26,311	\$ -	\$ 26,311	\$-	\$(26,311 )	\$ -
Counterparty 2	776	23	799	(23 )	(776 )	-
Counterparty 4	6,954	2,939	9,893	(7,697 )	(2,196 )	-
	34,041	2,962	37,003	(7,720 )	(29,283 )	-
Borrowings under repurchase arrangements	10,090,846	-	10,090,846	(10,090,846 )	-	-
	\$10,124,887	\$ 2,962	\$ 10,127,849	\$(10,098,566 )	\$(29,283 )	\$ -

Amounts presented are limited to recognized liabilities and cash collateral received associated with the indicated (a) counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.

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Amounts include accrued interest of \$11.7 million and \$10.9 million on interest rate swap agreements and \$6.4 (b) million and \$9.3 million on borrowings under repurchase arrangements, included in “Accounts payable and accrued expenses” on the face of the Balance Sheets as of September 30, 2016 and December 31, 2015, respectively.

Amounts presented are limited to recognized assets and collateral pledged associated with the indicated (c) counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.

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Changes in Accumulated other comprehensive income by component for the quarter and nine months ended September 30, 2016 were as follows (in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Total
Balance at June 30, 2016	\$ (61,526	) \$ 183,929	\$122,403
Activity for the quarter ended September 30, 2016:			
Other comprehensive income (loss) before reclassifications	12,558	(19,155	) (6,597 )
Amounts reclassified from accumulated other comprehensive income	4,927	–	4,927
Other comprehensive income (loss)	17,485	(19,155	) (1,670 )
Balance at September 30, 2016	\$ (44,041	) \$ 164,774	\$120,733
Balance at December 31, 2015	\$ (18,434	) \$ 154,529	\$136,095
Activity for the nine months ended September 30, 2016:			
Other comprehensive income (loss) before reclassifications	(41,714	) 10,245	(31,469 )
Amounts reclassified from accumulated other comprehensive income	16,107	–	16,107
Other comprehensive income (loss)	(25,607	) 10,245	(15,362 )
Balance at September 30, 2016	\$ (44,041	) \$ 164,774	\$120,733

## NOTE 8 ¾ UNSECURED BORROWINGS

Unsecured borrowings consist of 30-year junior subordinated notes issued in 2005 and 2006 and maturing in 2035 and 2036, for a total face amount of \$100 million. The notes are currently redeemable, in whole or in part, without penalty, at the Company's option. In 2015 the Company retrospectively adopted ASU 2015-03, which requires debt issuance costs to be recorded as direct deductions from the carrying amounts of the related liabilities, consistent with debt discounts. Note balances net of debt issuance costs, and related weighted average interest rates as of the indicated dates (calculated including issuance cost amortization and adjusted for effects of related Derivatives held as cash flow hedges) as of September 30, 2016 and December 31, 2015 were as follows (dollars in thousands):

	September 30, 2016		December 31, 2015	
	Borrowings Outstanding	Average Rate	Borrowings Outstanding	Average Rate
Junior subordinated notes maturing in:				
October 2035 (\$35,000 face amount)	\$ 34,267	7.92 %	\$ 34,234	7.91 %
December 2035 (\$40,000 face amount)	39,272	7.68	39,244	7.68
September 2036 (\$25,000 face amount)	24,526	7.72	24,508	8.96
	\$ 98,065	7.77	\$ 97,986	8.08

## NOTE 9 ¾ CAPITAL TRANSACTIONS

During the nine months ended September 30, 2016, Capstead issued an additional 48,000 shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program at an average price of \$24.05, net of underwriting fees and other costs, for net proceeds of \$1.2 million. While no shares were issued under this program during the quarter ended September 30, 2016, a modest amount of shares were issued subsequent to quarter-end through November 4, 2016.



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## NOTE 10 ¾ DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS

This note provides fair value-related disclosures as of the indicated balance sheet dates for Capstead's financial assets and liabilities, most of which are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management. With the exception of the fair value of lending counterparty investments, all fair values were determined using Level 2 Inputs in accordance with ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820). Lending counterparty investments are nonmarketable securities classified as assets for which Level 3 Inputs are used to determine fair value. These assets are considered strategic investments that are carried at cost and periodically valued and evaluated for impairment. No impairment charges have been recorded relative to these investments and the Company's cost basis is deemed to approximate fair value.

Residential mortgage investments, nearly all of which are mortgage securities classified as available-for-sale, are measured at fair value on a recurring basis. In determining fair value estimates the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for secured borrowings, provided such pricing levels are considered indicative of actual market clearing transactions. In determining fair value estimates for Secured borrowings with initial terms of greater than 120 days, the Company considers pricing levels indicated by lenders for entering into new transactions using similar pledged collateral with terms equal to the remaining terms of the these borrowings. The Company currently bases fair value for Unsecured borrowings on discounted cash flows using Company estimates for market yields. Prior to these borrowings' initial redemption dates, the Company considered then current pricing for financial instruments with similar characteristics in determining fair value estimates. Excluded from these disclosures are financial instruments for which cost basis is deemed to approximate fair value due primarily to the short duration of these instruments, which are valued using primarily Level 1 measurements, including Cash and cash equivalents, Cash collateral receivable from, or payable to, interest rate swap counterparties, receivables, payables and secured borrowings with initial terms of 120 days or less. See NOTE 7 for information relative to the valuation of interest rate swap agreements. Fair value-related disclosures for financial instruments other than debt securities were as follows as of the indicated dates (in thousands):

	September 30, 2016		December 31, 2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Residential mortgage loans	\$2,674	\$2,700	\$3,817	\$3,900
Lending counterparty investments	15,002	15,002	65,002	65,002
Portfolio-related interest rate swap agreements	2,501	2,501	7,720	7,720
Financial liabilities:				
Secured borrowings with initial terms of greater than 120 days	839,101	839,300	3,246,177	3,245,000
Unsecured borrowings	98,065	59,100	97,986	77,200
Interest rate swap agreements:				
Portfolio-related	5,981	5,981	1,051	1,051
Unsecured borrowings-related	40,973	40,973	25,010	25,010

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Fair value-related disclosures for debt securities were as follows as of the indicated dates (in thousands):

	Amortized Cost Basis	Gross Unrealized Gains	Losses	Fair Value
September 30, 2016				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	\$10,350,186	\$157,460	\$1,267	\$10,506,379
Ginnie Mae	3,062,593	14,795	6,214	3,071,174
Residential mortgage securities classified as held-to-maturity	2,096	25	–	2,121
December 31, 2015				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	10,331,965	166,794	10,954	10,487,805
Ginnie Mae	3,661,766	11,705	13,016	3,660,455
Residential mortgage securities classified as held-to-maturity	2,660	44	–	2,704

	September 30, 2016		December 31, 2015	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities in an unrealized loss position:				
One year or greater	\$813,179	\$ 4,923	\$597,652	\$ 4,259
Less than one year	1,114,807	2,558	4,468,844	19,711
	\$1,927,986	\$ 7,481	\$5,066,496	\$ 23,970

Capstead's investment strategy involves managing a leveraged portfolio of relatively short-duration ARM Agency Securities and management expects these securities will be held until payoff absent a major shift in strategy or a severe contraction in the Company's ability to obtain financing to support its portfolio. Declines in fair value caused by increases in interest rates are typically modest for investments in short-duration ARM Agency Securities compared to investments in longer-duration ARM or fixed-rate assets. These declines are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment.

From a credit risk perspective, federal government support for Fannie Mae and Freddie Mac helps ensure that fluctuations in value due to credit risk associated with these securities will be limited. Given that (a) any existing unrealized losses on mortgage securities held by the Company are not attributable to credit risk and declines in fair value of ARM securities due to changes in interest rates are generally recoverable in a relatively short period of time, (b) the Company typically holds its investments to maturity, and (c) it is more likely than not that the Company will not be required to sell any of its investments given the resiliency of the financing market for Agency Securities, none of these investments were considered other-than-temporarily impaired at September 30, 2016.

NOTE 11  $\frac{3}{4}$  COMPENSATION PROGRAMS

The compensation committee of Capstead's board of directors (the "Committee") is responsible for establishing, implementing, and monitoring the Company's compensation programs and practices. Incentive compensation programs adopted by the Committee for key executives are largely nondiscretionary, formulaic and target-based utilizing multiple pre-established performance goals (referred to as "metrics") and defined threshold, target and maximum award amounts determined by reference to established percentages of base salaries. Prior to granting awards, the Committee reviews the Company's programs, implementing any desired changes in performance metrics and the composition of mortgage REIT industry peer groups used for relative performance metric measurement purposes, as well as establishing each executive's targeted award opportunity. Equity-based awards and other long-term incentive awards are made pursuant to the Company's Amended and Restated 2014 Flexible Incentive Plan,



approved by stockholders in May 2014. At September 30, 2016, this plan had 3,688,541 shares of common stock remaining available for future issuances.

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## Short-term Incentive Compensation Programs

Under the provisions of Capstead's annual incentive compensation program, each participating executive has an overall target award opportunity equal to 125% of base salary. Awards are earned based on (a) relative and absolute economic return (change in book value per share of common stock plus common stock dividends divided by beginning book value per share), (b) relative operating cost efficiency (operating expenses divided by Unsecured borrowings and Stockholders' equity), and (c) attainment of individual goals and objectives. Each performance metric is assigned a weighting and performance relative to each metric is calculated separately. No awards can be earned for performance below defined threshold return levels and awards are capped for performance above defined maximum return levels. Included in Accounts payable and accrued expenses at September 30, 2016 are annual incentive compensation accruals for participating executives (other than the Company's former CEO), together with discretionary accruals for all other employees, totaling \$1.1 million. Recognized in Compensation-related expense are \$292,000 and \$1.1 million related to annual incentive compensation for all employees excluding the former CEO for the quarter and nine months ended September 30, 2016, respectively. An additional \$655,000 was recognized in Compensation-related expense during the quarter ended March 31, 2016 related to the March 2016 finalization of 2015 program results.

The Committee administers an additional performance-based short-term incentive compensation program for key executives that provides for quarterly cash payments equal to per share dividends declared on Capstead's common stock multiplied by a notional amount of non-vesting shares of common stock ("Dividend Equivalent Rights" or "DERs"). DERs only represent the right to receive the same cash distributions that the Company's common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. Included in Accounts payable and accrued expenses and recognized in Compensation-related expense are third quarter 2016 DERs distribution amounts totaling \$100,000 that were paid in October 2016 to executives other than the former CEO. For the nine months ended September 30, 2016, \$420,000 was recognized in Compensation-related expense related to the DERs program.

In February 2016 the Committee modified the relative weightings of the various metrics in the annual incentive compensation program for 2016 primarily to place more emphasis on absolute economic return at adjusted threshold, target and maximum return levels, while decreasing other relative weightings. Additionally, maximum payout percentage opportunities related to achieving or exceeding individual goals and objectives were increased and the term of outstanding DERs was extended to December 31, 2016.

## Long-term Equity-based Awards – Performance-based RSUs

Capstead's performance-based long-term incentive compensation program for key executives provides for the grant of performance-based RSUs that are convertible into shares of common stock following three-year performance periods, contingent upon whether, and to what extent, defined performance levels established for certain relative and absolute return performance metrics are met or exceeded. The relative return metrics measure the Company's performance on the basis of relative economic return and relative total stockholder return (change in stock price plus reinvested dividends). The absolute economic return metric measures performance against defined return levels. For conversion purposes, each performance metric is assigned a weighting and the Company's performance relative to each metric is calculated separately. The actual number of shares of common stock the units can convert into for each of the metrics, if any, can range from one-half of a share per unit if that metric's threshold level of performance is met, to two shares per unit if the related maximum level of performance is met or exceeded, adjusted for the weighting assigned to the metric. If a metric's threshold performance level is not met, no shares are issuable under that metric. Dividends accrue from the date of grant and will be paid in cash when the units convert into shares of common stock based on the number of shares ultimately issued, if any.



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Pursuant to this program, in February 2016, January 2015 and December 2013 the Committee granted 269,354, 247,512 and 242,505 RSUs with three-year performance periods ending December 31, 2018, 2017 and 2016, respectively. Initial grant date fair values developed for compensation cost purposes of \$8.03, \$8.83 and \$12.45 were assigned to the units of each grant, respectively. Due to lowered expectations for attainment of certain performance metrics, the three-year cost estimate associated with the December 2013 grant has been reduced three times since issuance (in June 2016, December 2015 and December 2014), ultimately to \$3.81 per unit. With the April 2015 resignation of a participating executive, 37,199 and 36,467 RSUs issued in 2015 and 2013, respectively, were forfeited. With the July 2016 resignation of the former CEO, 99,527 and 93,058 RSUs issued in 2016 and 2015, respectively, are expected to be forfeited by year-end. Recognized in Compensation-related expense are \$237,000 and \$786,000 related to outstanding RSUs for the quarter and nine months ended September 30, 2016, respectively. Included in Common stock dividends payable at September 30, 2016 are estimated dividends payable pertaining to these awards of \$308,000.

## Long-term Equity-based Awards – Stock Awards

Under a performance-based stock award program last utilized in 2012, the Committee granted common stock awards to all employees with staggered three-year vesting periods. These awards vest if annualized returns in excess of established return levels are generated during three-year measurement periods, with certain deferred vesting provisions that extend to include the seventh calendar year after the year of grant. Program grants for 118,784 shares with an average grant date fair value of \$12.17 vested in January 2016 pertaining to the measurement period ending December 31, 2015. The last shares granted under this program totaling 62,137 shares with a grant date fair value of \$11.67 are scheduled to vest in February 2017, assuming performance criteria and service conditions are met.

In February 2016 the Committee granted service-based stock awards for 67,337 shares of common stock with a grant date fair value of \$9.32 per share to key executives that are scheduled to vest in February 2019 assuming service conditions are met. With the July 2016 resignation of the former CEO, stock awards for 24,881 shares are expected to be forfeited by year-end. In January 2016 and December of 2014 and 2013, respectively, the Committee granted service-based stock awards for 61,272, 37,237 and 35,703 shares of common stock with grant date fair values of \$7.87, \$12.47 and \$12.34 per share to employees not awarded RSUs. These awards vest in January of 2019, 2018 and 2017, respectively, assuming service conditions are met.

As a component of the Company's director compensation program, directors are granted common stock awards annually upon election or re-election to the board of directors that vest approximately one year from issuance. In July 2016, director common stock awards for a total of 35,000 shares granted in July 2015 with a grant date fair value of \$11.41 per share vested and new awards, for a total of 41,881 shares, with a grant date fair value of \$10.03 per share were granted that will vest on July 15, 2017.

Performance-based and service-based stock award activity for the nine months ended September 30, 2016 is summarized below:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested stock awards outstanding at December 31, 2015	288,861	\$ 11.98
Grants	170,490	8.97
Vestings	(153,784 )	12.00
Unvested stock awards outstanding at September 30, 2016	305,567	10.29

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During the quarter and nine months ended September 30, 2016, the Company recognized in Compensation-related expense \$189,000 and \$630,000, respectively, related to amortization of the grant date fair value of employee stock awards. The amounts amortized for these periods assumed that any applicable performance metrics would continue to be met for related initial measurement periods. Included in Common Stock dividends payable at September 30, 2016 are estimated dividends payable pertaining to these awards of \$332,000. In addition, the Company recognized in Other general and administrative expense \$104,000 and \$304,000 related to amortization of the grant date fair value of director stock awards during the quarter and nine months ended September 30, 2016, respectively. Unrecognized compensation expense for unvested stock awards for all employees and directors other than the former CEO totaled \$1.3 million as of September 30, 2016, to be expensed over a weighted average period of 1.3 years (assumes minimal employee and director attrition and any applicable performance metrics would continue to be met for related initial measurement periods).

Service-based stock awards issued to directors and to employees not awarded RSUs receive dividends on a current basis without risk of forfeiture if the related awards do not vest. Outstanding performance-based stock awards and stock awards issued to key executives defer the payment of dividends accruing between the grant dates and the end of related performance or service periods. If these awards do not vest, the related accrued dividends will be forfeited.

Long-term Equity-based Awards – Option Awards

At September 30, 2016 option awards for 40,000 shares of common stock were outstanding with a weighted average strike price of \$11.86. These awards are currently exercisable, have no aggregate intrinsic value and have a weighted average remaining contractual term of 1.7 years. No option award activity occurred during the quarter and nine months ended September 30, 2016. All outstanding option awards were granted prior to 2010, have ten-year contractual terms and were issued with strike prices equal to the closing market price of Capstead's common stock on the dates of grant. The fair value of these awards was estimated at that time using a Black-Scholes option pricing model and was expensed over the related vesting periods.

Other Benefit Programs

Capstead sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its executives. In general the Company matches up to 50% of a participant's voluntary contribution up to a maximum of 6% of a participant's base salary and annual incentive compensation payments. The Company also makes discretionary contributions of up to another 3% of such compensation regardless of participation in the plans. Company contributions are subject to certain vesting requirements that have been met by nearly all of Capstead's current employees. During the quarter and nine months ended September 30, 2016, the Company recognized in Compensation-related expense \$33,000 and \$220,000 related to contributions to these plans, respectively.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FINANCIAL CONDITION

Overview

Capstead operates as a self-managed REIT earning income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of short-duration ARM Agency Securities, which reset to more current interest rates within a relatively short period of time and are considered to have limited, if any, credit risk. See NOTE 1 to the consolidated financial statements (included under Item 1 of this report) for defined terms used in this discussion and analysis. By investing in short-duration ARM Agency Securities, the Company is positioned to benefit from future recoveries in financing spreads that typically contract during periods of rising interest rates and to experience smaller fluctuations in portfolio values compared to leveraged portfolios containing a significant amount of longer-duration ARM or fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk.

Capstead finances its residential mortgage investments by leveraging its long-term investment capital with secured borrowings consisting primarily of borrowings under repurchase arrangements with commercial banks and other financial institutions. Long-term investment capital totaled \$1.37 billion at September 30, 2016, consisting of \$1.07 billion of common and \$198 million of preferred stockholders' equity together with \$98 million of unsecured borrowings maturing in 2035 and 2036 (recorded amounts). Long-term investment capital decreased by \$28 million during the nine months ended September 30, 2016 as increases in unrealized portfolio gains and modest issuances of Series E preferred stock pursuant to an at-the-market continuous offering program were more than offset by unrealized losses on interest rate swap agreements held for hedging purposes and dividend distributions in excess of earnings. As of September 30, 2016, no shares had been repurchased pursuant the Company's \$100 million common stock repurchase program announced in January 2016.

Capstead's residential mortgage investments portfolio decreased by 4.0% (\$572 million) during the first nine months of 2016 to \$13.58 billion at September 30, 2016, primarily as a result of portfolio runoff outpacing acquisitions, particularly during the third quarter. Secured borrowings declined by 4.1% to \$12.43 billion. Portfolio leverage (secured borrowings divided by long-term investment capital) decreased to 9.09 to one at September 30, 2016 from 9.28 to one at December 31, 2015. Management believes current portfolio leverage levels represent an appropriate use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

Capstead reported net income of \$16 million and \$65 million or \$0.13 and \$0.56 per diluted common share for the quarter and nine months ended September 30, 2016, respectively, compared to \$21 million and \$80 million or \$0.18 and \$0.72 per diluted common share for the same periods in 2015, respectively. Earnings in 2016 have been negatively impacted by higher investment premium amortization caused by higher mortgage prepayment levels and higher borrowing costs. Additionally, third quarter 2016 earnings include a \$0.03 per share separation of service charge associated with the July 2016 resignation of the Company's former President and Chief Executive Officer. The Company declared a third quarter 2016 common dividend of \$0.23 per share that was paid on October 20, 2016 to holders of record on September 30, 2016.

The size and composition of Capstead's investment portfolio depends on investment strategies being implemented by management, as well as overall market conditions, including the availability of attractively priced investments and suitable financing to leverage the Company's investment capital. Market conditions are influenced by, among other things, current and future expectations for short-term interest rates, mortgage prepayments and market liquidity.



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Risk Factors and Critical Accounting Policies

Under the captions “Risk Factors” and “Critical Accounting Policies” are discussions of risk factors and critical accounting policies affecting Capstead’s financial condition and earnings that are an integral part of this discussion and analysis. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company and its financial results.

Common Stock Repurchase Program

On January 27, 2016 Capstead’s board of directors authorized the repurchase of up to \$100 million in common stock when such repurchases are deemed appropriate relative to portfolio reinvestment options and liquidity needs. As of November 4, 2016, no shares had been repurchased under this program.

Any repurchases made pursuant to the program will be made in the open market from time to time in accordance with and as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors. In addition, the Company may enter into Rule 10b5-1 plans under which repurchases can be made. The authorization does not obligate the Company to acquire any particular amount of common stock and repurchases under the program and the program itself may be suspended or discontinued at the Company’s discretion without prior notice.

Preferred Equity Capital Issuances

During the nine months ended September 30, 2016, Capstead issued an additional 48,000 shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program at an average price of \$24.05, net of underwriting fees and other costs, for net proceeds of \$1.2 million. While no shares were issued under this program during the quarter ended September 30, 2016, a modest amount of shares were issued subsequent to quarter-end through November 4, 2016.

Additional amounts of Series E preferred capital may be raised in the future under this program or by other means, subject to market conditions, compliance with federal securities laws and tax regulations as well as blackout periods associated with the dissemination of important Company-specific news.

Book Value per Common Share

All but less than \$5 million of Capstead’s residential mortgage investments portfolio and all of its interest rate swap agreements are recorded at fair value on the Company’s balance sheet and are therefore included in the calculation of book value per share of common stock (total stockholders’ equity, less liquidation preferences for outstanding shares of preferred stock, divided by outstanding shares of common stock). The Company’s borrowings, however, are not recorded at fair value on the balance sheet. See NOTE 10 to the consolidated financial statements (included under Item 1 of this report) for additional disclosures regarding fair values of financial instruments held by the Company.

Fair value is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels, among other factors. The Company’s investment strategy attempts to mitigate these risks by focusing on investments in Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans with interest rates that reset periodically to more current levels, generally within five years. Because of these characteristics, the fair value of the Company’s portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to leveraged portfolios containing a significant amount of non-agency securities or longer-duration ARM and/or fixed-rate Agency Securities.





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The following table illustrates the progression of Capstead's book value per share of common stock as well as changes in book value expressed as percentages of beginning book value for the quarter and nine months ended September 30, 2016:

	Quarter Ended September 30, 2016		Nine Months Ended September 30, 2016	
Book value per common share, beginning of period	\$ 11.21		\$ 11.42	
Change in unrealized gains and losses on mortgage securities classified as available-for-sale	(0.20 )		0.11	
Change in unrealized gains and losses on interest rate swap agreements designated as cash flow hedges of:				
Secured borrowings	0.19		(0.10 )	
Unsecured borrowings	—		(0.17 )	
	(0.01 )	(0.1 )%	(0.16 )	(1.4 )%
Capital transactions:				
Dividend distributions in excess of earnings	(0.10 )	(0.9 )%	(0.16 )	(1.4 )%
Book value per common share, end of period	\$ 11.10		\$ 11.10	
Decrease in book value per common share during the indicated periods	\$ (0.11 )	(1.0 )%	\$ (0.32 )	(2.8 )%

## Residential Mortgage Investments

The following table illustrates the progression of Capstead's portfolio of residential mortgage investments for the quarter and nine months ended September 30, 2016 (dollars in thousands):

	Quarter Ended September 30, 2016		Nine Months Ended September 30, 2016	
Residential mortgage investments, beginning of period	\$ 13,901,543		\$ 14,154,737	
Portfolio acquisitions (principal amount) at average lifetime purchased yields of 2.10% and 2.23%, respectively	779,620		2,243,808	
Investment premiums on acquisitions*	27,462		76,011	
Portfolio runoff (principal amount)	(1,071,071 )	)	(2,807,339 )	)
Investment premium amortization	(36,076 )	)	(95,139 )	)
(Decrease) Increase in net unrealized gains on securities classified as available-for-sale	(19,155 )	)	10,245	)
Residential mortgage investments, end of period	\$ 13,582,323		\$ 13,582,323	
Decrease in residential mortgage investments during the indicated periods	\$ (319,220 )	)	\$ (572,414 )	)

Residential mortgage investments typically are acquired at a premium to the securities' unpaid principal balances.

\* Investment premiums are recognized in earnings as portfolio yield adjustments using the interest method over the estimated lives of the related investments. As such, the level of mortgage prepayments impacts how quickly investment premiums are amortized.

Capstead's investment strategy focuses on managing a portfolio of residential mortgage investments consisting almost exclusively of ARM Agency Securities. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by Fannie Mae and Freddie Mac, which are federally

chartered corporations, or Ginnie Mae, which is an agency of the federal government. Federal government support for Fannie Mae and Freddie Mac has largely alleviated market concerns regarding the ability of Fannie Mae and Freddie Mac to fulfill their guarantee obligations.

By focusing on investing in short-duration ARM Agency Securities, changes in fair value caused by changes in interest rates are typically relatively modest compared to changes in fair value of longer-duration ARM or fixed-rate assets. Declines in fair value caused by increases in interest rates are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment. This investment strategy positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates.

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Capstead classifies its ARM securities based on the average length of time until the loans underlying each security reset to more current rates (“months-to-roll”) (less than 18 months for “current-reset” ARM securities, and 18 months or greater for “longer-to-reset” ARM securities). The Company’s ARM holdings featured the following characteristics at September 30, 2016 (dollars in thousands):

ARM Type	Amortized Cost Basis <sup>(a)</sup>	Net WAC <sup>(b)</sup>	Fully Indexed WAC <sup>(b)</sup>	Average Net Margins <sup>(b)</sup>	Average Periodic Caps <sup>(b)</sup>	Average Lifetime Caps <sup>(b)</sup>	Months To Roll
Current-reset ARMs:							
Fannie Mae Agency Securities	\$4,132,930	2.64	% 2.98	% 1.70	% 3.18	% 9.57	% 5.9
Freddie Mac Agency Securities	1,683,157	2.74	3.16	1.82	2.67	9.61	6.9
Ginnie Mae Agency Securities	1,813,753	2.30	2.12	1.51	1.06	8.30	6.3
Residential mortgage loans	1,913	3.80	2.91	2.08	1.63	11.04	4.9
(57% of total)	7,631,753	2.58	2.82	1.68	2.57	9.27	6.2
Longer-to-reset ARMs:							
Fannie Mae Agency Securities	2,528,932	2.72	3.18	1.62	3.33	7.73	41.8
Freddie Mac Agency Securities	2,005,159	2.73	3.21	1.66	2.80	7.80	43.0
Ginnie Mae Agency Securities	1,248,840	2.92	2.10	1.51	1.04	7.96	41.3
(43% of total)	5,782,931	2.76	2.95	1.61	2.65	7.80	42.1
	\$13,414,684	2.66	2.88	1.65	2.60	8.64	21.7
Gross WAC (rate paid by borrowers) <sup>(c)</sup>		3.26					

Amortized cost basis represents the Company’s investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. At September 30, 2016, the ratio of amortized cost basis to unpaid (a) principal balance for the Company’s ARM holdings was 103.21. This table excludes \$3 million in fixed-rate agency-guaranteed mortgage pass-through securities, residential mortgage loans and private residential mortgage pass-through securities held as collateral for structured financings.

Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments, net of servicing and other fees as of the indicated date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. As such, it is similar to the cash yield on the portfolio which is calculated using amortized cost basis. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average net margins represent the weighted average levels over the underlying indexes that the portfolio can adjust to upon reset, usually subject to initial, periodic and/or lifetime (b) caps on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. ARM securities with initial fixed-rate periods of five years or longer typically have either 200 or 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities held by the Company are subject only to lifetime caps or are not subject to a cap. For presentation purposes, average periodic caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime caps. At quarter-end, 71% of current-reset ARMs were subject to periodic caps averaging 1.74%; 20% were subject to initial caps averaging 3.55%; 8% were subject to lifetime caps averaging 7.39%; and 1% were not subject to a cap. All longer-to-reset ARM securities at September 30, 2016 were subject to initial caps.

(c) Gross WAC is the weighted average interest rate of the mortgage loans underlying the indicated investments, including servicing and other fees paid by borrowers, as of the indicated balance sheet date.



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ARM securities held by Capstead are backed by mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. These coupon interest rate adjustments are usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. After the initial fixed-rate period, if applicable, the coupon interest rates of mortgage loans underlying the Company's ARM securities typically adjust either (a) annually based on specified margins over the one-year London interbank offered rate ("LIBOR") or the one-year Constant Maturity U.S. Treasury Note Rate ("CMT"), (b) semiannually based on specified margins over six-month LIBOR, or (c) monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index.

After consideration of any applicable initial fixed-rate periods, at September 30, 2016 approximately 89%, 7% and 4% of the Company's ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly, respectively. Approximately 80% of the Company's current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an initial coupon reset date. Additionally, at September 30, 2016 approximately 8% of the Company's ARM securities were backed by interest-only loans, with remaining interest-only payment periods averaging 22 months. All percentages are based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated date.

## Secured Borrowings

Capstead finances its residential mortgage investments by leveraging its long-term investment capital with secured borrowings consisting primarily of borrowings under repurchase arrangements with commercial banks and other financial institutions. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of each repurchase arrangement and receives the related principal and interest payments.

In August 2015 the Company began supplementing its borrowings under repurchase arrangements with advances from the Federal Home Loan Bank ("FHLB") of Cincinnati. On January 12, 2016 the FHLB system regulator finalized rules originally proposed in 2014 that generally preclude captive insurers from remaining members beyond February 19, 2017 with transition rules that require outstanding advances to be repaid upon maturity or by that date. In response to this action, the Company has migrated all but \$250 million of its \$2.88 billion of FHLB advances outstanding at December 31, 2015 back to repurchase arrangements and anticipates migrating remaining balances away from the FHLB in November 2016. FHLB stock held by the Company in connection with advance activity was reduced by \$50 million during the nine months ended September 30, 2016 and the remaining \$10.0 million held at September 30, 2016 is expected to be redeemed by December 31, 2016.

The terms and conditions of secured borrowings are negotiated on a transaction-by-transaction basis when each such borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. Collateral requirements in excess of amounts borrowed (referred to as "haircuts") averaged 4.6 percent and ranged from 2.0 to 5.0 percent of the fair value of pledged residential mortgage pass-through securities at September 30, 2016. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had \$681 million of capital at risk with its lending counterparties at September 30, 2016. The Company did not have capital at risk with any single counterparty exceeding 4.7% of total stockholders' equity at September 30, 2016.

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Secured borrowing rates are generally fixed based on prevailing rates corresponding to the terms of the borrowings. Interest may be paid monthly or at the termination of a borrowing at which time the Company may enter into a new borrowing at prevailing haircuts and rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly security pay-down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. Conversely, if collateral fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls.

As of September 30, 2016 the Company's secured borrowings totaled \$12.43 billion with 23 counter-parties at average rates of 0.72%, before the effects of currently-paying interest rate swap agreements held as cash flow hedges and 0.86% including the effects of these derivatives. To help mitigate exposure to rising short-term interest rates, the Company uses pay-fixed, receive-variable interest rate swap agreements with two- and three-year interest payment terms supplemented with longer-maturity secured borrowings, when available at attractive rates and terms. Excluding \$800 million notional amount of swap agreements that expired October 1, 2016, at quarter-end the Company held \$7.05 billion notional amount of portfolio financing-related interest rate swap agreements with contract expirations occurring at various dates through the third quarter of 2019 and a weighted average expiration of 14 months.

After consideration of all portfolio financing-related swap positions entered into as of quarter-end, the Company's residential mortgage investments and secured borrowings had estimated durations at September 30, 2016 of 10½ and 8 months, respectively, for a net duration gap of approximately 2½ months – see pages 33 and 34 under the caption “Interest Rate Risk” for further information about the Company's sensitivity to changes in market interest rates. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-maturity secured borrowings, if available at attractive rates and terms.

Utilization of Long-term Investment Capital and Potential Liquidity

Capstead's investment strategy involves managing an appropriately leveraged portfolio of ARM Agency Securities that management believes can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. The potential liquidity inherent in the Company's unencumbered residential mortgage investments is as important as the actual level of cash and cash equivalents carried on the balance sheet because secured borrowings generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Potential liquidity is affected by, among other factors:

- current portfolio leverage levels,
- changes in market value of assets pledged and interest rate swap agreements held for hedging purposes as determined by lending and swap counterparties,
- mortgage prepayment levels,
- collateral requirements of lending and swap counterparties, and
- general conditions in the commercial banking and mortgage finance industries.

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Capstead's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of September 30, 2016 in comparison with December 31, 2015 (in thousands):

	Investments <sup>(a)</sup>	Secured Borrowings	Capital Employed	Potential Liquidity <sup>(b)</sup>	Portfolio Leverage
Balances as of September 30, 2016:					
Residential mortgage investments	\$ 13,582,323	\$ 12,431,839	\$ 1,150,484	\$ 530,789	
Cash collateral receivable from swap counterparties, net <sup>(c)</sup>			28,738	–	
Other assets, net of other liabilities			188,953	83,697	
			\$ 1,368,175	\$ 614,486	9.09:1
Balances as of December 31, 2015	\$ 14,154,737	\$ 12,958,394	\$ 1,396,310	\$ 702,881	9.28:1

(a) Investments are stated at balance sheet carrying amounts, which generally reflect estimated fair value as of the indicated dates.

(b) Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted financing arrangements considering management's estimate of the fair value of residential mortgage investments held as of the indicated dates adjusted for other sources of liquidity such as cash and cash equivalents.

(c) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties, if applicable, and the fair value of interest rate swap positions as of the indicated date.

In order to efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (remitted to the Company 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to address challenging market conditions and limits exposure to any individual counterparty.

Future levels of portfolio leverage will be dependent on many factors, including the size and composition of the Company's investment portfolio (see "Liquidity and Capital Resources"). Portfolio leverage decreased from year-end primarily because of lower borrowing requirements resulting from a 4.0% decline in portfolio balances that was partially offset by a \$28 million reduction in long-term investment capital. Potential liquidity declined during this period due largely to higher mortgage securities principal remittance receivables as a result of higher levels of portfolio runoff, capital deployed to support swap positions and the decline in long-term investment capital. Management believes current portfolio leverage levels represent an appropriate use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.



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## Supplemental Analysis of Quarterly Financing Spreads

Quarterly financing spreads and mortgage prepayment rates were as follows for the indicated periods:

	2016			2015			2014		
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4	
Total financing spreads: <sup>(a)</sup>									
Yields on all interest-earning assets	1.45 %	1.53 %	1.69 %	1.62 %	1.40 %	1.42 %	1.66 %	1.61 %	
Borrowing rates on all interest-paying liabilities	0.89	0.89	0.87	0.79	0.74	0.68	0.65	0.63	
Total financing spreads	0.56	0.64	0.82	0.83	0.66	0.74	1.01	0.98	
Financing spreads on residential mortgage investments, a non-GAAP financial measure:									
Cash yields on residential mortgage investments <sup>(b)</sup>	2.52	2.50	2.47	2.44 %	2.42 %	2.41 %	2.42 %	2.43 %	
Investment premium amortization <sup>(b)</sup>	(1.06)	(0.96)	(0.75)	(0.81)	(0.99)	(0.95)	(0.72)	(0.77)	
Yields on residential mortgage investments	1.46	1.54	1.72	1.63	1.43	1.46	1.70	1.66	
Unhedged secured borrowing rates <sup>(c)</sup>	0.69	0.67	0.65	0.48	0.45	0.41	0.38	0.36	
Hedged secured borrowing rates <sup>(c)</sup>	0.93	0.96	0.93	0.87	0.84	0.77	0.75	0.72	
Secured borrowing rates	0.84	0.84	0.82	0.73	0.69	0.62	0.59	0.56	
Financing spreads on residential mortgage investments	0.62	0.70	0.90	0.90	0.74	0.84	1.11	1.10	
Constant prepayment rate ("CPR")	25.80	23.19	18.23	19.62	23.21	21.98	16.66	17.58	

All interest-earning assets include residential mortgage investments, overnight investments and cash collateral <sup>(a)</sup>receivable from interest rate swap counterparties. All interest-paying liabilities include unsecured borrowings and cash collateral payable to interest rate swap counterparties.

Cash yields are based on the cash component of interest income. Investment premium amortization is determined <sup>(b)</sup>using the interest method which incorporates actual and anticipated future mortgage prepayments. Both are expressed as a percentage calculated on average amortized cost basis for the indicated periods.

Unhedged borrowing rates represent average rates on secured borrowings, before consideration of related currently-paying interest rate swap agreements. Hedged borrowing rates represent the average fixed-rate payments made on currently-paying interest rate swap agreements held for portfolio hedging purposes adjusted for differences between LIBOR-based variable-rate payments received on these swaps and unhedged borrowing rates, <sup>(c)</sup>as well as the effects of any hedge ineffectiveness. Average fixed-rate swap payments were 0.75%, 0.73% and 0.69% for the third, second and first quarters of 2016, respectively, while the variable-rate payment adjustments equated to 0.18%, 0.23% and 0.24% on average currently-paying swap notional amounts outstanding for the same periods, respectively. During 2015 fixed-rate swap payments averaged 0.57% while variable-rate payment adjustments averaged 0.24% on average notional amounts outstanding.

Cash yields continue to benefit from higher coupon interest rates as mortgage loans underlying the Company's current-reset ARM securities reset to higher rates based on higher prevailing six- and 12-month interest rate indices. The majority of these loans reset annually based on margins over indices such as the 12-month LIBOR, which increased 32 basis points during the third quarter of 2016 to 1.55% at September 30, 2016, driven by money market reform and market volatility associated with changing expectations regarding Federal Reserve interest rate policy. This index also increased considerably during the fourth quarter of 2015 reflecting expectations for higher short-term

interest rates, culminating in the December 2015 Federal Funds Rate increase.

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Portfolio yield adjustments for investment premium amortization are primarily driven by mortgage prepayment and investment premium levels. Mortgage prepayment levels are heavily influenced by the availability of mortgage financing at attractive terms and the overall health of the housing markets, as well as seasonal factors. Similar to what occurred in 2015; Capstead has experienced high prepayment levels during the summer months of 2016 reflecting declines in prevailing interest rates and seasonal factors. With ten-year U.S. Treasury yields recovering from the lows seen in early July and the end of the summer selling season, the current refinancing wave appears to have peaked in September, which should allow for lower investment premium amortization during the upcoming winter months.

Higher unhedged borrowing rates thus far in 2016 are primarily attributable to higher rates negotiated with lending counterparties after the December Federal Funds Rate increase. Rates are also being influenced by market volatility associated with changing expectations regarding future Federal Reserve interest rate policy and quarter-end bank balance sheet constraints. The regulator-induced moratorium on FHLB advances in mid-January also contributed marginally to higher unhedged borrowing rates as lower-cost FHLB advances were replaced with repurchase arrangements. Fixed swap rates increased steadily during 2016 as expiring swap contracts were replaced at higher rates, even as variable-rate swap receipts benefited more recently from higher prevailing short-term LIBOR rates.

## Reconciliation of GAAP and non-GAAP Financing Spread Disclosures

Financing spreads on residential mortgage investments differ from total financing spreads, an all-inclusive GAAP measure, that is based on all interest-earning assets and liabilities. Management believes presenting financing spreads on residential mortgage investments provides useful information for evaluating portfolio performance. The following reconciles these measures for the indicated periods:

	2016			2015			2014	
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Total financing spreads	0.56%	0.64%	0.82%	0.83%	0.66%	0.74%	1.01%	0.98%
Impact of yields on other interest-earning assets*	0.01	0.01	0.03	0.01	0.03	0.04	0.04	0.05
Impact of borrowing rates on other interest-paying liabilities*	0.05	0.05	0.05	0.06	0.05	0.06	0.06	0.07
Financing spreads on residential mortgage investments	0.62	0.70	0.90	0.90	0.74	0.84	1.11	1.10

	Nine Months Ended September 30	
	2016	2015
Total financing spreads	0.67%	0.80%
Impact of yields on other interest-earning assets*	0.01	0.03
Impact of borrowing rates on other interest-paying liabilities*	0.06	0.06
Financing spreads on residential mortgage investments	0.74	0.89

Other interest-earning assets consist of overnight investments and cash collateral receivable from interest rate swap counterparties. Other interest-paying liabilities consist of unsecured borrowings (at average borrowing rates of 8.04% and 8.06% for the quarter and nine months ended September 30, 2016, respectively) and cash collateral payable to interest rate swap counterparties.

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## RESULTS OF OPERATIONS

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Income statement data: (in thousands, except per share data)				
Interest income on residential mortgage investments (before investment premium amortization)	\$85,921	\$83,808	\$257,793	\$250,929
Investment premium amortization	(36,076)	(34,323)	(95,139)	(92,458)
Related interest expense	(26,636)	(22,272)	(80,232)	(61,584)
	23,209	27,213	82,422	96,887
Other interest income (expense)	(1,796)	(2,034)	(5,429)	(6,086)
	21,413	25,179	76,993	90,801
Other revenue (expense):				
Compensation-related expense	(1,299)	(3,064)	(6,565)	(7,573)
Separation of service charge	(2,740)	–	(2,740)	–
Other general and administrative expense	(1,239)	(1,309)	(3,565)	(3,628)
Miscellaneous other revenue	305	261	1,300	368
	(4,973)	(4,112)	(11,570)	(10,833)
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Net income per diluted common share	\$0.13	\$0.18	\$0.56	\$0.72
Average diluted shares outstanding	95,866	95,721	95,799	95,695
Key operating statistics: (dollars in millions)				
Average yields:				
Residential mortgage investments:				
Cash yields	2.52	% 2.42	% 2.49	% 2.41
Investment premium amortization	(1.06)	) (0.99)	) (0.92)	) (0.89)
Adjusted yields	1.46	1.43	1.57	1.52
Other interest-earning assets	0.38	0.14	0.29	0.12
Total average yields	1.45	1.40	1.56	1.49
Average borrowing rates:				
Secured borrowings:				
Unhedged borrowing rates	0.69	0.45	0.67	0.41
Hedged borrowing rates	0.93	0.84	0.94	0.79
Adjusted portfolio-related borrowing rates	0.84	0.69	0.83	0.63
Unsecured borrowings	8.04	8.49	8.06	8.49
Total average borrowing rates	0.89	0.74	0.89	0.69
Average total financing spreads	0.56	0.66	0.67	0.80
Average financing spreads on residential mortgage investments, a non-GAAP financial measure*	0.62	0.74	0.74	0.89
Average net yield on total interest-earning assets	0.62	0.71	0.74	0.85
Average CPR	25.80	23.21	22.41	20.62
Average balance information:				
Residential mortgage investments (cost basis)	\$13,629	\$13,885	\$13,771	\$13,858
Other interest-earning assets	182	255	187	309
Secured borrowings	12,731	13,010	12,879	13,009
Currently-paying swap agreements (notional amounts)	7,602	7,794	7,535	7,529
Unsecured borrowings (included in long-term investment capital)	98	98	98	98
Long-term investment capital (“LTIC”)	1,380	1,475	1,389	1,492
Operating costs as a percentage of average LTIC	0.73	% 1.18	% 0.97	% 1.00

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Return on average LTIC	6.10	6.24	7.13	7.73
Return on average common equity capital	4.62	5.80	6.59	7.64

Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on Capstead's residential mortgage investments, net of secured borrowing rates, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive \*GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 29 for a reconciliation of these financial measures and the Company's rationale for using this non-GAAP financial measure.

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Capstead's net income totaled \$16 million and \$65 million or \$0.13 and \$0.56 per diluted common share for the quarter and nine months ended September 30, 2016, respectively, compared to \$21 million and \$80 million or \$0.18 and \$0.72 per diluted common share for the same periods in 2015. Earnings in 2016 have been negatively impacted by higher investment premium amortization caused by higher mortgage prepayment levels and higher borrowing costs. Additionally, third quarter 2016 earnings include a \$0.03 per share separation of service charge associated with the July 2016 resignation of the Company's former President and Chief Executive Officer.

Total financing spreads were lower, averaging 0.56% and 0.67% for the quarter and nine months ended September 30, 2016, respectively, compared to 0.66% and 0.80% for the same periods in 2015 as higher cash yields and rates on overnight investments were offset by higher investment premium amortization and higher secured borrowing rates. Financing spreads on residential mortgage investments were lower, averaging 0.62% and 0.74% for the quarter and nine months ended September 30, 2016, respectively, compared to 0.74% and 0.89% for the same periods in 2015 as higher cash yields were offset by higher investment premium amortization and higher secured borrowing rates. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on residential mortgage investments, net of secured borrowing rates adjusted for currently-paying interest rate swap agreements held for hedging purposes. See page 29 for the Company's rationale for using this non-GAAP financial measure and a reconciliation to total financing spreads.

Yields on residential mortgage investments were higher, averaging 1.46% and 1.57% during the quarter and nine months ended September 30, 2016, respectively, compared to 1.43% and 1.52% for the same periods in 2015. Cash yields were higher, averaging 2.52% and 2.49% during the quarter and nine months ended September 30, 2016, compared to 2.42% and 2.41% for both the same periods in 2015, largely due to ARM loan coupon interest rates resetting higher to more current rates. Yield adjustments for investment premium amortization were also higher, averaging 106 and 92 basis points during the quarter and nine months ended September 30, 2016, respectively, compared to 99 and 89 basis points for the same periods in 2015 primarily as a result of higher mortgage prepayment rates. Mortgage prepayment levels are influenced by the availability of mortgage financing at attractive terms and the health of the housing markets as well as seasonal factors.

Secured borrowing rates adjusted for currently-paying interest rate swap agreements held for hedging purposes were higher, averaging 0.84% and 0.83% during the quarter and nine months ended September 30, 2016, respectively, compared to 0.69% and 0.63% for the same periods in 2015. Unhedged borrowing rates accounted for most of the increase, with the remainder attributable to higher interest rate swap costs. Market conditions, including the 25 basis point increase in the Federal Funds Rate in December 2015, contributed to higher borrowing rates. Swap costs were impacted by the expiration of older, lower-rate swaps, partially offset by higher variable rate swap receipts as a result of higher short-term LIBOR rates. Average fixed-rate swap payments were 75 and 72 basis points for the quarter and nine months ended September 30, 2016, respectively, compared to 57 and 55 basis points for the same periods in 2015. Variable-rate payment adjustments equated to 18 and 22 basis points on average currently-paying swap notional amounts outstanding for the quarter and nine months ended September 30, 2016, respectively, compared to 27 and 24 basis points for the same periods in 2015. Currently-paying swap balances were relatively stable, averaging \$7.60 billion and \$7.54 billion for the quarter and nine months ended September 30, 2016, respectively, compared to \$7.79 billion and \$7.53 billion for the quarter and nine months ended September 30, 2015. Future secured borrowing rates will be dependent on market conditions, including overall levels of market interest rates as well as the availability of longer-maturity borrowings and interest rate swap agreements at attractive rates.

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Other interest income (expense) benefited during the quarter and nine months ended September 30, 2016 from higher rates on overnight investments as a result of the December 2015 Fed rate increase, and lower hedged borrowing rates on the Company's \$100 million face amount of outstanding unsecured borrowings compared to amounts reported for the same periods in 2015.

Operating costs (compensation, general and administrative expenses) as a percentage of long-term investment capital is a metric widely used in the mortgage REIT industry as a measure of operating cost efficiency and Capstead is widely recognized as an industry leader in this regard. Operating costs for the third quarter of 2016 were lower than in a more typical quarter due largely to the effects of the July resignation of the Company's former CEO. In comparison to prior year periods, operating costs also benefited from lower short- and long-term incentive compensation accrual requirements. As further described in NOTE 11 to the accompanying consolidated financial statements (included in Item 1 of this report), the Company's compensation programs are based in part on relative and absolute economic return performance metrics. Economic return is defined as the change in book value per share of common stock plus common stock dividends declared divided by beginning book value per share.

Miscellaneous other revenue was higher for the quarter and nine months ended September 30, 2016 compared to the same periods in 2015 primarily because of the inclusion of dividends on FHLB stock held by the Company in connection with FHLB advance activity.

## LIQUIDITY AND CAPITAL RESOURCES

Capstead's primary sources of funds are secured borrowings and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down secured borrowings to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity inherent in its unencumbered residential mortgage investments is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under "Utilization of Long-term Investment Capital and Potential Liquidity" on page 27 illustrates management's estimate of additional funds potentially available to the Company at September 30, 2016 and the accompanying discussion provides insight into the Company's perspective on what level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for the Company's continued qualification as a REIT.

On January 27, 2016 Capstead's board of directors authorized the repurchase of up to \$100 million in common stock when such repurchases are deemed appropriate relative to portfolio reinvestment options and liquidity needs. As of November 4, 2016, no shares had been repurchased under this program.

Capstead finances its residential mortgage investments primarily by borrowing under repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis, when each such borrowing is initiated or renewed. In August 2015 the Company began supplementing its traditional borrowings with FHLB advances; however, in early 2016 the FHLB system regulator issued a ruling generally eliminating the mortgage REIT industry's access to such advances. In response to this action, the Company has migrated all but \$250 million of its \$2.88 billion of FHLB advances outstanding at December 31, 2015 back to repurchase arrangements as of September 30, 2016 and anticipates migrating remaining balances away from the FHLB by November 2016. FHLB stock held by the Company in connection with advance activity totaling \$10.0 million at September 30, 2016 is expected to be redeemed by December 31, 2016.

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None of the Company's borrowing counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. Future borrowings are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Secured borrowings totaled \$12.43 billion at September 30, 2016, with \$12.29 billion maturing within 90 days. Secured borrowings began the year at \$12.96 billion and averaged \$12.73 billion and \$12.88 billion during the quarter and nine months ended September 30, 2016, respectively.

Average secured borrowings can differ from period-end balances for a number of reasons including portfolio growth or contraction, as well as differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to rising short-term interest rates, the Company uses pay-fixed, receive-variable interest rate swap agreements supplemented with longer-maturity secured borrowings when available at attractive rates and terms. Excluding \$800 million notional amount of swap agreements that expired October 1, 2016, at September 30, 2016 the Company held \$7.05 billion notional amount of portfolio financing-related interest rate swap agreements with contract expirations occurring at various dates through the third quarter of 2019 and a weighted average expiration of 14 months. Relative to the 20-year floating rate terms of the Company's \$100 million face amount of unsecured borrowings, the Company entered into forward-starting swap agreements to effectively lock in lower fixed rates of interest on these borrowings. The Company intends to continue to utilize suitable derivative financial instruments such as interest rate swap agreements and longer-maturity secured borrowings to manage interest rate risk when available at attractive rates and terms.

During the nine months ended September 30, 2016, Capstead issued 48,000 shares, of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program for net proceeds of \$1 million. While no shares were issued under this program during the quarter ended September 30, 2016, a modest amount of shares were issued subsequent to quarter-end through November 4, 2016. Additional amounts of Series E preferred capital and new common equity capital may be raised in the future under continuous offering programs or by other means. Any such capital raising activity will be subject to market conditions such as pricing levels for these securities, capital deployment opportunities or needs, the status of stock repurchase programs, if applicable, as well as compliance with federal securities laws and tax regulations as well as blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

## Interest Rate Risk

Because Capstead's residential mortgage investments consist almost entirely of Agency Securities, which are considered to have limited, if any, credit risk, interest rate risk is the primary market risk faced by the Company. Interest rate risk is highly sensitive to a number of factors, including economic conditions, government fiscal policy, central bank monetary policy and banking regulation. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration ARM or fixed-rate assets. These declines can be recovered in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment. This strategy also positions the Company to benefit from future recoveries in financing spreads that typically contract during periods of rising interest rates.

To further reduce exposure to higher short-term interest rates, the Company uses interest rate swap agreements that typically require interest payments for two-year terms, as well as longer-maturity secured borrowings, if available at attractive rates and terms. These transactions lengthen the effective duration of the Company's secured borrowings to more closely match the duration of its portfolio of residential mortgage investments. After consideration of portfolio financing-related swap positions held to hedge changes in short-term interest rates, at September 30, 2016 the Company's residential mortgage investments and secured borrowings had estimated durations of 10½ and 8 months, for a net duration gap of approximately 2½ months. The Company intends to continue to manage interest rate risk



associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements and longer-maturity secured borrowings, if available at attractive rates and terms.

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Capstead performs sensitivity analyses using a model to estimate the effects that specific interest rate changes can reasonably be expected to have on net interest margins and portfolio values. All investments, secured borrowings and related derivative financial instruments held are included in these analyses. For net interest margin modeling purposes, the model incorporates management's assumptions for mortgage prepayment levels for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums and reinvesting portfolio runoff. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity. For portfolio valuation modeling purposes, a static portfolio is assumed.

This model is the primary tool used by management to assess the direction and magnitude of changes in net interest margins and portfolio values resulting solely from changes in interest rates. Key modeling assumptions include mortgage prepayment speeds, adequate levels of market liquidity, current market conditions, and portfolio leverage levels. Given the present low level of interest rates, a floor of 0.00% is assumed. However, it is assumed that borrowing rates cannot decline beyond a floor of 0.15%. These assumptions are inherently uncertain and, as a result, modeling cannot precisely estimate the impact of higher or lower interest rates. Actual results will differ from simulated results due to the timing, magnitude and frequency of interest rate changes, other changes in market conditions, changes in management strategies and other factors.

The table below reflects the estimated impact of instantaneous parallel shifts in the yield curve on net interest margins and the fair value of Capstead's portfolio of residential mortgage investments and related derivative financial instruments as of the indicated dates, subject to the modeling parameters described above.

	Federal Funds Rate	10-year U.S. Treasury Rate	Down 0.50%	Up 0.50%	Up 1.00%
Projected 12-month percentage change in net interest margins: *					
September 30, 2016	0.25-0.50%	1.60	% (10.5)%	1.9 %	(0.8 )%
December 31, 2015	0.25-0.50	2.27	(9.2 )	(0.1 )	(5.3 )
Projected percentage change in portfolio and related derivative values: *					
September 30, 2016	0.25-0.50	1.60	–	(0.2 )	(0.5 )
December 31, 2015	0.25-0.50	2.27	0.1	(0.3 )	(0.5 )

Sensitivity of net interest margins as well as portfolio and related derivative values to changes in interest rates is determined relative to the actual rates at the applicable date. Note that the projected 12-month net interest margin \* change is predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices, if investments made will behave in the same fashion as assets currently held or if management will choose to replace runoff with such assets.

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RISK FACTORS

An investment in securities issued by Capstead involves various risks. An investor should carefully consider the following risk factors in conjunction with the other information contained in this document before purchasing the Company's securities. The risks discussed herein can adversely affect the Company's business, liquidity, operating results, financial condition and future prospects, causing the market price of the Company's securities to decline, which could cause an investor to lose all or part of his/her investment. The risk factors described below are not the only risks that may affect the Company. Additional risks and uncertainties not presently known to the Company also may adversely affect its business, liquidity, earnings and financial condition.

Risks Related to Capstead's Business

An increase in prepayments may adversely affect Capstead's liquidity, financial condition and earnings. When short- and long-term interest rates are at nearly the same levels (i.e., a "flat yield curve" environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases due to the availability of lower mortgage interest rates to homeowners. Mortgage interest rates and the general availability of mortgage credit can also be impacted by regulatory changes in Agency guarantee fees, loan level pricing adjustments, down payment requirements, as well as other underwriting requirements. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's portfolio of residential mortgage investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums, which could adversely affect earnings. High levels of mortgage prepayments can also lead to larger than anticipated demands on the Company's liquidity from its lending counterparties, as more fully described below. Additionally, periods of high prepayments can adversely affect pricing for Agency Securities in general and, as a result, book value per common share can be adversely affected due to declines in the fair value of the Company's remaining portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

Changes in interest rates, whether increases or decreases, may adversely affect Capstead's liquidity, financial condition and earnings. Capstead's earnings depend primarily on the difference between the interest received on its residential mortgage investments and the interest paid on its secured borrowings, net of the effect of derivative financial instruments held for hedging purposes. The Company finances its investments primarily at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on secured borrowings not effectively fixed through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more extreme circumstances, negative financing spreads and, therefore, adversely affect earnings. Because rising interest rates tend to put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods, adversely affecting the Company's liquidity. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining secured borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

During periods of relatively low short-term interest rates, declines in the indices used to determine coupon interest rate resets for ARM loans may adversely affect yields on the Company's ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company's borrowing rates, earnings would be adversely affected.



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Periods of illiquidity in the mortgage markets may reduce amounts available under secured borrowing arrangements due to declines in the perceived value of related collateral, which could adversely impact Capstead's liquidity, financial condition and earnings. Capstead finances its residential mortgage investments by pledging them as collateral under uncommitted secured borrowing arrangements. The amount borrowed is limited to a percentage of the market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by or pledged to the lender in excess of the amount borrowed is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the perceived market value of the pledged collateral as determined by the Company's lenders declines, the Company may be subject to margin calls wherein the lender requires the Company to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, the Company may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, lenders can liquidate the collateral or seek other remedies, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining secured borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to the Company and/or the amounts individual counterparties are willing to lend, which could adversely affect the Company's liquidity, financial condition and earnings. Capstead enters into secured borrowing arrangements with numerous commercial banks and other financial institutions, both foreign and domestic, routinely with maturities of 30 to 90 days. The Company's ability to achieve its investment objectives depends on its ability to re-establish or roll maturing secured borrowings on a continuous basis and none of the Company's counterparties are obligated to enter into new borrowing transactions at the conclusion of existing transactions. If a counterparty chooses not to roll a maturing borrowing, the Company must pay off the borrowing, generally with cash available from another secured borrowing arrangement entered into with another counterparty. If the Company determines that it does not have sufficient borrowing capacity with its remaining counterparties, it could be forced to sell assets under potentially adverse market conditions, which could result in losses. An industry-wide reduction in the availability of secured borrowings could adversely affect pricing levels for Agency Securities leading to further declines in the Company's liquidity and book value per common share. Under these conditions, the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

If Capstead is unable to negotiate favorable terms and conditions on future secured borrowings with one or more of the Company's lending counterparties, the Company's liquidity, financial condition and earnings could be adversely impacted. The terms and conditions of each secured borrowing arrangement are negotiated on a transaction-by-transaction basis. Key terms and conditions include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on future secured borrowings. During periods of market illiquidity or due to perceived credit deterioration of the collateral pledged or the Company itself, a lender may require that less favorable asset pricing procedures be employed, margin requirements be increased and/or may choose to limit or completely curtail lending to the Company. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining secured borrowings, which could result in losses.

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Capstead's use of borrowings under repurchase arrangements may expose the Company to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to the Company. Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a simultaneous agreement to repurchase the transferred assets at a future date. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to the Company and subject the Company to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

Capstead's use of borrowings under repurchase arrangements may give lending counterparties greater rights if the Company seeks bankruptcy protection, exposing the Company to losses. Borrowings under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. If the Company files for bankruptcy, these lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses to the extent of any margin amounts held by the lending counterparties.

Capstead may sell assets for various reasons, including a change in the Company's investment focus, which could increase earnings volatility. Capstead may periodically sell assets to enhance its liquidity during periods of market illiquidity or rising interest rates or the Company may change its investment focus requiring it to sell some portion of its existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-maturity secured borrowings or interest rate swap agreements, could increase the Company's earnings volatility.

Capstead may invest in derivative financial instruments such as interest rate swap agreements to mitigate or hedge the Company's interest rate risk, which may adversely affect the Company's liquidity, financial condition or earnings. The Company may invest in such instruments from time to time with the goal of partially offsetting changes in value of its residential mortgage investments as a result of changes in interest rates and achieving more stable borrowing costs over an extended period. However, these activities may not have the desired beneficial impact on the Company's liquidity, financial condition or earnings. For instance, the pricing of residential mortgage investments and the pricing of related derivatives may deteriorate at the same time leading to margin calls by counterparties to both the borrowings supporting these investments and the derivatives, adversely impacting the Company's liquidity and financial condition. In addition, counterparties could fail to honor their commitments under the terms of the derivatives or have their credit quality downgraded impairing the value of the derivatives. In the event of any defaults by counterparties, the Company may have difficulty recovering its cash collateral receivable from its counterparties and may not receive payments provided for under the terms of the derivatives and as a result, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates.

Derivative financial instruments held may fail to qualify for hedge accounting introducing potential volatility to Capstead's earnings. The Company typically qualifies derivative financial instruments held as cash flow hedges for accounting purposes in order to record the effective portion of the change in fair value of derivatives as a component of stockholders' equity rather than in earnings. If the hedging relationship for any derivative held ceases to qualify for hedge accounting treatment for any reason, including failing to meet documentation and ongoing hedge effectiveness requirements, the Company would be required to record in earnings the total change in fair value of any such derivative. In addition the Company could elect to no longer avail itself of cash flow hedge accounting for its derivative positions. Such changes could introduce a potentially significant amount of volatility to earnings reported by the Company.

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The lack of availability of suitable investments at attractive pricing may adversely affect Capstead's earnings. The pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than Capstead. Additionally, in recent years the federal government, primarily through the Federal Reserve, has been an active buyer of Agency Securities which has had the effect of supporting, if not increasing, pricing for these securities. To the extent the proceeds from prepayments on Capstead's mortgage investments are not reinvested or cannot be reinvested at rates of return at least equal to the rates previously earned on those investments, the Company's earnings may be adversely affected. Similarly, if proceeds from capital raising activities are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can the Company assure investors that it will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

Monetary policy actions by the Federal Reserve could adversely affect Capstead's liquidity, financial condition and earnings. Since 2008 the Federal Reserve has employed a number of relatively unorthodox policy initiatives, most notably the purchase of U.S. Treasury securities and fixed-rate Agency Securities. This expansion of the Federal Reserve's balance sheet is often referred to as quantitative easing or QE. The policy goals of the QE initiatives were to support Fannie Mae, Freddie Mac and the housing markets, and otherwise improve economic and labor market conditions by exerting downward pressure on longer term interest rates, including mortgage interest rates. The Federal Reserve ceased buying additional Treasury and Agency Securities in late 2014, while continuing to replace portfolio runoff and has indicated that it intends to eventually curtail replacing portfolio runoff when economic conditions allow.

In general, QE has elevated pricing levels for Agency Securities resulting in lower yields on new purchases, lower mortgage interest rates and higher mortgage prepayment rates. The Company's net interest margins, and therefore earnings, were adversely affected over time as existing, lower-cost portfolio was replaced with higher-cost, lower-yielding securities. See previous discussion regarding the negative effects of higher mortgage prepayment levels.

With the Federal Reserve concluding its bond buying program and eventually allowing its existing holdings to begin running off, pricing for ARM Agency securities could be negatively affected as the buy-side support of such a large market participant is removed. In addition, should the Federal Reserve decide to eventually reduce its holdings of fixed-rate Agency Securities through asset sales, the pricing for all Agency Securities could decline. These actions could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described above.

Potential changes in the relationship between the federal government and Fannie Mae and Freddie Mac could adversely affect Capstead's liquidity, financial condition and earnings. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest on these securities are guaranteed by Fannie Mae, Freddie Mac or by Ginnie Mae. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. The high actual or perceived credit quality of Agency Securities allows the Company to finance its portfolio using secured borrowing arrangements with favorable interest rate terms and margin requirements that otherwise would not be available. As a result of deteriorating housing market conditions that began in 2007, Fannie Mae and Freddie Mac incurred substantial losses due to high levels of mortgagor defaults and in 2008 the FHFA placed Fannie Mae and Freddie Mac into conservatorship, allowing it to operate them without forcing them to liquidate. Additionally, the federal government, through the U.S. Treasury and the Federal Reserve, undertook other actions to provide financial support to these entities and the housing market, including the acquisition of large holdings of Agency Securities. These and other steps taken by the federal government were designed to support market stability and mortgage availability at favorable rates in part by providing additional confidence to investors in

Agency Securities.

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It is anticipated that over the next several years U.S. policy makers will reach a consensus on what the long-term role of the federal government in general, and Fannie Mae and Freddie Mac in particular, will have in the housing markets. In this regard there have been numerous proposals put forth by members of Congress, the Treasury Department and federal regulators regarding Fannie Mae and Freddie Mac reform. The actual or perceived credit quality of Agency Securities could be adversely affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between Fannie Mae, Freddie Mac and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Fannie Mae, Freddie Mac or Ginnie Mae, or their successors could adversely affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of short-duration Agency Securities remains viable, which could adversely affect earnings and book value per common share.

Failure of the federal government to reduce future annual federal budget deficits could adversely impact Capstead's liquidity, financial condition and earnings. The increasing amount of outstanding federal debt relative to the size of the U.S. economy, particularly in light of projected growth in federal government spending and resulting federal budget deficits, could eventually lead to a decline in the market's perception of the creditworthiness of the federal government. Because market participants rely on the federal government's continued support of Fannie Mae and Freddie Mac, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings of Agency Securities could be adversely affected. In addition, political discord over U.S. fiscal policy could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of secured borrowings which could adversely impact the Company's liquidity, earnings and book value per common share, as more fully described above.

Legislative and additional regulatory actions could adversely affect the availability and/or terms and conditions of secured borrowings and consequently, the Company's liquidity, financial condition and earnings. In 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") in order to restrict certain business practices of systemically significant participants in the financial markets, which include many of the Company's lending counterparties. Additionally, changes in regulatory capital requirements and other leverage constraints are being implemented worldwide. It remains unclear how significant of an impact Dodd Frank and changes in regulatory capital requirements will have on the financial markets in general and on the Company's strategy of holding a leveraged portfolio of Agency Securities. However, it is possible that the availability and/or terms and conditions of secured borrowings could be adversely affected which could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described above.

Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects. As a self-managed REIT with 13 full-time employees and one part-time employee, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. While certain of the Company's named executive officers and other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

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Risks Related to Capstead's Status as a REIT and Other Tax Matters

If Capstead does not qualify as a REIT, the Company will be subject to tax as a regular corporation and face substantial tax liability. Capstead has elected to be taxed as a REIT for federal income tax purposes and intends to continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize the Company's REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for the Company to qualify as a REIT.

If Capstead fails to qualify as a REIT in any tax year, then:

the Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates;

any resulting tax liability could be substantial and would reduce the cash available for distribution to stockholders;

the Company would not be required to make income distributions; and

unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years and, as a result, the Company's cash available for distribution to stockholders would be reduced during these years.

Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings. Even if Capstead remains qualified for taxation as a REIT, the Company may be subject to certain federal, state and local taxes on its income and assets. For example, the Company:

will be required to pay tax on any undistributed REIT taxable income,

may be subject to the "alternative minimum tax" on any tax preference items, and

may operate taxable REIT subsidiaries subject to tax on any taxable income earned.

Complying with REIT requirements may limit Capstead's ability to hedge effectively. The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from unqualified hedges, together with any other income not generated from qualified real estate assets, to no more than 25% of gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect the profitability of these transactions or activities. If the Company fails to satisfy the REIT gross income tests it could lose its REIT status for federal income tax purposes unless the failure was due to reasonable cause and not due to willful neglect.

Complying with REIT requirements may cause Capstead to forego otherwise attractive opportunities. To qualify as a REIT for federal income tax purposes, Capstead must continually satisfy tests concerning, among other things, the sources of its income, the nature and diversification of its assets, the amounts that it distributes to its stockholders, and the ownership of its stock. The Company may be required to make distributions to stockholders at disadvantageous

times or when it does not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder the Company's ability to operate solely on the basis of maximizing profits.

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Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments. To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of the Company's investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of the Company's assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. Beginning in 2018 the threshold for this limitation is reduced to 20%. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders. As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed taxable income. In addition, the Company will be subject to a 4% nondeductible excise tax if the actual amount that it pays out to its stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, the Company may generate taxable income greater than its net income for financial reporting purposes or its taxable income may be greater than the Company's cash flow available for distribution to stockholders. If the Company does not have other funds available in these situations, it could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable it to pay out enough of its taxable income to satisfy the distribution requirement and to avoid corporate income tax or the 4% excise tax in a particular year. These alternatives could increase the Company's costs and reduce its long-term investment capital.

Distributions payable by Capstead do not qualify for the reduced tax rates applicable to "qualified dividends." The maximum tax rate applicable to income from non-REIT corporate qualified dividends payable to domestic stockholders that are individuals, trusts or estates is currently 20%. Distributions of ordinary income payable by REITs, however, generally are not eligible for the reduced rates. Although this does not adversely affect the taxation of REITs or distributions payable by REITs, the more favorable rates applicable to regular corporate qualified dividends could cause investors who are individuals, trusts or estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of REIT stocks.

Capstead may be subject to adverse legislative or regulatory tax changes that could reduce the market price of the Company's securities. Federal income tax laws or the administrative interpretations of those laws can change at any time. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect Capstead or its stockholders. The Company cannot predict any impact on the value of its securities from adverse legislative or regulatory tax changes.

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An investment in Capstead's securities has various federal, state and local income tax risks that could affect the value of an investor's investment. The Company strongly urges investors to consult their own tax advisor concerning the effects of federal, state and local income tax law on an investment in the Company's securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

### Risk Factors Related to Capstead's Corporate Structure

There are no assurances of Capstead's ability to pay dividends in the future. Capstead intends to continue paying quarterly dividends and to make distributions to its stockholders in amounts such that all or substantially all of the Company's taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable the Company to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, the Company's ability to pay dividends may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of the Company's board of directors and will depend upon the Company's earnings, its financial condition, maintenance of its REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of the Company's ability to pay dividends in the future.

Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations. The Investment Company Act of 1940 (the "40 Act") exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the 40 Act. For over 30 years, the staff of the SEC has interpreted the provisions of the 40 Act to require, among other things, a REIT to maintain at least 55% of its assets directly in qualifying real estate interests and at least 80% of its assets in real estate-related assets in order to be exempt from regulation as an investment company. Critical to the Company's exemption from regulation as an investment company is the long-standing SEC staff interpretation that so-called whole loan mortgage securities, in which an investor holds all issued certificates with respect to an underlying pool of mortgage loans, constitute qualifying real estate interests for purposes of the staff's 55% qualifying real estate interest requirement.

Conversely, so-called partial pool mortgage securities presently do not qualify for purposes of meeting the 55% requirement, although they are considered by the staff to be real estate-related assets for purposes of meeting the staff's 80% real estate-related asset requirement.

In August 2011, the SEC staff issued a request for information (Concept Release No. IC-29778) from industry participants and investors regarding, among other things, its past interpretations of the 40 Act real estate exemption, including the interpretations described above, raising concerns that the SEC may issue a proposal for rulemaking that could overturn some of the staff's past interpretations regarding the real estate exemption. If the SEC or its staff adopts contrary interpretations of the 40 Act and the Company and other similar REITs become subject to regulation as investment companies, the industry's use of leverage would be substantially reduced. Absent a restructuring of the Company's business operations to avoid such regulation, this could require the sale of most of the Company's portfolio of Agency Securities under potentially adverse market conditions resulting in losses and significantly reduce future net interest margins and earnings.

Pursuant to Capstead's charter, its board of directors has the ability to limit ownership of the Company's capital stock, to the extent necessary to preserve its REIT qualification. For the purpose of preserving Capstead's REIT qualification, the Company's charter gives the board the ability to repurchase outstanding shares of capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of the

Company's outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

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Because provisions contained in Maryland law and Capstead's charter may have an anti-takeover effect, investors may be prevented from receiving a "control premium" for their shares. Provisions contained in Capstead's charter and Maryland general corporation law can delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a "control premium" for their shares. For example, these provisions may defer or prevent tender offers for the Company's common stock or purchases of large blocks of the Company's common stock, thereby limiting the opportunities for its stockholders to receive a premium over then-prevailing market prices. These provisions include the following:

Repurchase rights – Repurchase rights granted to Capstead's board in its charter limit related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize the Company's REIT status.

- Classification of preferred stock – Capstead's charter authorizes the board to issue preferred stock and establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval and could have the effect of delaying or preventing someone from taking control of the Company.

Statutory provisions – Capstead is subject to provisions of Maryland statutory law that restrict business combinations with interested stockholders and restrict voting rights of certain shares acquired in control share acquisitions. The board has not taken any action to exempt the Company from these provisions.

Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of Maryland corporations may not be required to act in takeover situations under the same standards as apply in Delaware and certain other corporate jurisdictions.

There are risks associated with ownership of Capstead's Series E preferred stock. Risks associated with ownership of the Company's Series E preferred stock include:

Redemption rights – The Series E preferred stock is redeemable by the Company, in whole or in part, at any time on or after May 13, 2018, or pursuant to a Special Optional Redemption Right upon the occurrence of a Change of Control, as both terms are defined in the Series E Articles Supplementary, at a cash redemption price of \$25.00 plus all accrued and unpaid dividends to, but not including, the date of redemption, which may be less than the prevailing market price for shares of the Series E preferred stock.

Limited conversion rights – Holders of shares of the Series E preferred stock may convert into shares of common stock only upon the occurrence of a Change of Control, and only if the Company does not exercise its Special Optional Redemption Right. Even if this were to occur, it may not be economically advantageous to convert based on then-existing conversion ratios and trading levels of the common stock.

Subordination – The Series E preferred stock is subordinate to all of the Company's existing and future debt. None of the provisions relating to the Series E preferred stock limit the Company's ability to incur future debt. Future debt may include restrictions on the Company's ability to pay dividends on, redeem, or pay the liquidation preference on shares of the Series E preferred stock.

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Dilution through issuance of additional shares of preferred stock – The Company’s charter currently authorizes the issuance of up to 100 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to the Series E preferred stock would dilute the interests of Series E preferred stockholders, and could affect the Company’s ability to pay dividends on, redeem, or pay the liquidation preference on, the Series E preferred stock. None of the provisions relating to the Series E preferred stock limit the Company’s ability to issue additional preferred stock on parity with Series E preferred stock.

Limited voting rights – Voting rights as a holder of Series E preferred stock are limited. The Company’s common stock is currently the only class of stock carrying full voting rights. Voting rights for holders of shares of Series E preferred stock exist primarily with respect to (i) adverse changes in the terms of the Series E preferred stock, (ii) the creation of additional classes or series of preferred stock that are senior to the Series E preferred stock, and (iii) the non-payment of six quarterly Series E dividends (whether or not consecutive).

Capstead may change its policies without stockholder approval. Capstead’s board and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company’s stockholders. Policy changes could adversely affect the Company’s financial condition, results of operations, the market price of its common and preferred stock or the Company’s ability to pay dividends or distributions.

**CRITICAL ACCOUNTING POLICIES**

Management’s discussion and analysis of financial condition and results of operations is based upon Capstead’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that can affect the reported amounts of assets, liabilities (including contingencies), revenues and expenses, as well as related disclosures. These estimates are based on available internal and market information and appropriate valuation methodologies believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the expected useful lives and carrying values of assets and liabilities which can materially affect the determination of net income and book value per common share. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following are critical accounting policies in the preparation of Capstead’s consolidated financial statements that involve the use of estimates requiring considerable judgment:

Amortization of investment premiums on residential mortgage investments – Investment premiums on residential mortgage investments are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. The single largest determinant in amortizing investment premiums is actual portfolio runoff (scheduled and unscheduled principal paydowns) for a given accounting period. This is because the investment premium associated with actual runoff is amortized when the runoff occurs pursuant to the interest method. Amortization is also affected by estimates and judgments related to future levels of mortgage prepayments used in determining additional amortization that may be necessary to achieve the required effective yield over the estimated life of the related investment.



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Mortgage prepayment expectations can change based on how current and projected changes in interest rates impact the economic attractiveness of mortgage refinance opportunities, if available, and other factors such as lending industry underwriting practices and capacity constraints, regulatory changes, borrower credit profiles and the health of the economy and housing markets. Management estimates future mortgage prepayments based on these factors and past experiences with specific investments within the portfolio. Should actual prepayment rates differ materially from these estimates, investment premiums would be expensed at a different pace.

Fair value and impairment accounting for residential mortgage investments – Nearly all of Capstead’s residential mortgage investments are held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in Stockholders’ equity as a component of Accumulated other comprehensive income. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions and the perceived credit quality of Agency Securities. Judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 10 to the consolidated financial statements (included under Item 1 of this report) for discussion of how Capstead values its residential mortgage investments.

Generally, gains or losses are recognized in earnings only if securities are sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of Other revenue (expense) if the decline was credit-related or it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary impairment of a mortgage security due to other factors would be recognized in Accumulated other comprehensive income.

Accounting for derivative financial instruments – Capstead uses derivatives for risk management purposes. Derivatives are recorded as assets or liabilities and carried at fair value and consequently, changes in value of these instruments enter into the calculation of book value per common share. Fair values fluctuate with current and projected changes in interest rates and other factors such as the Company’s and its counterparties’ nonperformance risk. Judgment is required to develop estimated fair values.

The accounting for changes in fair value of each derivative held depends on whether it has been designated as an accounting hedge, as well as the type of hedging relationship identified. To qualify as a cash flow hedge for accounting purposes, at the inception of the hedge relationship the Company must anticipate and document that the hedge relationship will be highly effective and must monitor ongoing effectiveness on at least a quarterly basis. As long as the hedge relationship remains effective, the effective portion of changes in fair value of the derivative is recorded in Accumulated other comprehensive income and the ineffective portion is recorded in earnings as a component of Interest expense. The effective portion of changes in fair value is reclassified from Accumulated comprehensive income to earnings over the term of the derivative primarily in the form of derivative cash flows that are either in excess of or lower than market rates. Changes in fair value of derivatives not held as accounting hedges, or for which the hedge relationship is deemed to no longer be highly effective and as a result hedge accounting is terminated, are recorded in earnings as a component of Other revenue (expense).

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The Company currently uses interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of current and anticipated future 30- and 90-day secured borrowings and the 20-year floating-rate periods of unsecured borrowings. Variable-rate payments to be received on swap agreements and any measured hedge ineffectiveness are recorded in interest expense as an offset to interest owed on related designated borrowings while fixed-rate swap payments to be made are also recorded in interest expense resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTE 7 to the consolidated financial statements (included under Item 1 of this report) and “Financial Condition – Residential Mortgage Investments” for additional information regarding the Company’s current use of derivatives and its related risk management policies.

STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

This document contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain the words “believe,” “anticipate,” “expect,” “estimate,” “intend,” “will be,” “will likely continue,” “will likely result,” or words or phrases of similar meaning. Forward-looking statements are based largely on the expectations of management and are subject to a number of risks and uncertainties including, but not limited to, the following:

- changes in general economic conditions;
- fluctuations in interest rates and levels of mortgage prepayments;
- the effectiveness of risk management strategies;
- the impact of differing levels of leverage employed;
- liquidity of secondary markets and credit markets;
- the availability of financing at reasonable levels and terms to support investing on a leveraged basis;
- the availability of new investment capital;
- the availability of suitable qualifying investments from both an investment return and regulatory perspective;
- changes in market conditions as a result of Federal Reserve monetary policy or federal government fiscal challenges;
- deterioration in credit quality and ratings of existing or future issuances of Fannie Mae, Freddie Mac or Ginnie Mae securities;
  - changes in legislation or regulation affecting Fannie Mae, Freddie Mac, Ginnie Mae, the Federal Home Loan Bank system and similar federal government agencies and related guarantees;

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• changes in legislation or regulation affecting exemptions for mortgage REITs from regulation under the Investment Company Act of 1940;

• other changes in legislation or regulation affecting the mortgage and banking industries; and

• increases in costs and other general competitive factors.

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. Forward-looking statements speak only as of the date the statement is made 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. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS**

The information required by this Item is incorporated by reference to the information included in Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations."

**ITEM 4. CONTROLS AND PROCEDURES**

As of September 30, 2016, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2016. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to September 30, 2016.

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PART II. ¾ OTHER INFORMATION

ITEM 6. EXHIBITS

<u>Exhibit Number</u>	<u>DESCRIPTION</u>
3.1	Charter, including Articles of Incorporation, Articles Supplementary for each series of preferred shares no longer outstanding and all other amendments to such Articles of Incorporation. <sup>(1)</sup>
3.2	Articles Supplementary classifying and designating the Registrant's 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, par value \$0.10 per share. <sup>(2)</sup>
3.3	Amended and Restated Bylaws. <sup>(3)</sup>
4.1	Specimen of Common Stock Certificate. <sup>(4)</sup>
4.2	Specimen of stock certificate evidencing the 7.50% Series E Cumulative Redeemable Preferred Stock of the Registrant, liquidation preference \$25.00 per share, par value \$0.10 per share. <sup>(2)</sup>
4.3	Junior Subordinated Indenture dated September 26, 2005. <sup>(5)</sup>
4.4	Indenture dated December 15, 2005. <sup>(5)</sup>
4.5	Indenture dated September 11, 2006. <sup>(5)</sup>
10.01	Amended and Restated Deferred Compensation Plan. <sup>(5)</sup>
10.02	Amended and Restated 2014 Flexible Incentive Plan. <sup>(6)</sup>
10.03	Amendment No. 1 to the Amended and Restated 2014 Flexible Incentive Plan. <sup>(7)</sup>
10.04	Second Amended and Restated Incentive Bonus Plan. <sup>(8)</sup>
10.05	Form of nonqualified stock option and stock award agreements for non-employee directors. <sup>(5)</sup>
10.06	Form of stock award agreements for employees with performance conditions. <sup>(9)</sup>
10.07	Form of stock award agreements for employees with performance conditions and deferral of dividends. <sup>(10)</sup>
10.08	2013 Annual Incentive Plan (short-term). <sup>(11)</sup>
10.09	2014 Annual Incentive Compensation Program (short-term). <sup>(3)</sup>
10.10	2014 Long-Term Award Criteria, as corrected. <sup>(3)</sup>
10.11	Form of performance unit agreement. <sup>(12)</sup>
10.12	2016 Annual Incentive Compensation Program. <sup>(13)</sup>
10.13	Form of restricted stock agreement for employees. <sup>(13)</sup>
10.14	2016 Long-Term Performance Unit Award Criteria. <sup>(13)</sup>
10.15	Form of performance unit agreement for employees. <sup>(13)</sup>
10.16	Sales agreement, dated January 23, 2015, by and between the Company and its continuous offering program sales manager. <sup>(14)</sup>
10.17	Severance agreement, dated May 3, 2016, by and between the Company and Roy S. Kim. <sup>(15)</sup>
10.18	Consulting Agreement, dated July 14, 2016, by and between the Company and Andrew F. Jacobs. <sup>(16)</sup>
<u>12</u>	Computation of ratio of net income to fixed charges and ratio of net income to combined fixed charges and preferred stock dividends.*
<u>31.1</u>	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
<u>32</u>	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

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Exhibit Number DESCRIPTION

101.INS	XBRL Instance Document*
101.SCH	XBRL Taxonomy Extension Schema*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase*
101.DEF	XBRL Additional Taxonomy Extension Definition Linkbase*
101.LAB	XBRL Taxonomy Extension Label Linkbase*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase*

- (1) Incorporated by reference to the Registrant's Annual Report on Form 10-K/A (No. 001-08896) for the year ended December 31, 2012.
- (2) Incorporated by reference to the Registrant's Registration of Certain Classes of Securities on Form 8-A (No. 001-08896) dated May 13, 2013.
- (3) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on February 3, 2014, for the event dated January 29, 2014.
- (4) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-63358) dated June 19, 2001.
- (5) Incorporated by reference to the Registrant's Annual Report on Form 10-K (No. 001-08896) for the year ended December 31, 2011.
- (6) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on May 30, 2014, for the event dated May 28, 2014.
- (7) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on February 20, 2015, for the event dated February 20, 2015.
- (8) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on May 5, 2011, for the event dated May 4, 2011.
- (9) Incorporated by reference to the Registrant's Annual Report on Form 10-K (No. 001-08896) for the year ended December 31, 2008.
- (10) Incorporated by reference to the Registrant's Annual Report on Form 10-K (No. 001-08896) for the year ended December 31, 2010.
- (11) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on October 23, 2013 for the event dated October 21, 2013.
- (12) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on January 6, 2015, for the event dated January 2, 2015.
- (13) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on February 4, 2016, for the event dated February 1, 2016.
- (14) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on January 29, 2015, for the event dated January 23, 2015.
- (15) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q (No. 001-08896) for the quarter ended March 31, 2016.
- (16) Incorporated by reference to the Registrant's Current Report on Form 8-K (No. 001-08896), filed on July 15, 2016, for the event dated July 14, 2016.

\* Filed herewith

\*\* Furnished herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CAPSTEAD MORTGAGE  
CORPORATION  
Registrant

Date: November 4, 2016 By: /s/ PHILLIP A. REINSCH  
Phillip A. Reinsch  
President and Chief Executive Officer,  
Chief Financial Officer and Secretary

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