

MFA FINANCIAL, INC.
Form 10-K
February 13, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2008

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: 1-13991

MFA FINANCIAL, INC.
(Previously known as MFA Mortgage Investments, Inc.)
(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

13-3974868
(I.R.S. Employer
Identification No.)

350 Park Avenue, 21st Floor, New York, New York
(Address of principal executive offices)

10022
(Zip Code)

(212) 207-6400
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Each Exchange on Which Registered |
|--|---|
| Common Stock, \$0.01 par value | New York Stock Exchange |
| 8.50% Series A Cumulative Redeemable Preferred Stock, \$0.01 par value | New York Stock Exchange |

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Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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
Non-accelerated filer

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

On June 30, 2008, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1,285,562,672 based on the closing sales price of our common stock on such date as reported on the New York Stock Exchange.

On February 10, 2009, the registrant had a total of 222,706,053 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement for the 2009 annual meeting of stockholders scheduled to be held on or about May 21, 2009 are incorporated by reference into Part III of this annual report on Form 10-K.

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CAUTIONARY STATEMENT – This annual report on Form 10-K may contain “forward-looking” statements within the meaning of Section 27A of the Securities Act of 1933, as amended (or 1933 Act), and Section 21E of the Securities Exchange Act of 1934, as amended (or 1934 Act). We caution that any such forward-looking statements made by us are not guarantees of future performance and that actual results may differ materially from those in such forward-looking statements. Some of the factors that could cause actual results to differ materially from estimates contained in our forward-looking statements are set forth in this annual report on Form 10-K for the year ended December 31, 2008. See Item 1A “Risk Factors” of this annual report on Form 10-K.

In this annual report on Form 10-K, references to “we,” “us,” or “our” refer to MFA Financial, Inc. (formerly known as MFA Mortgage Investments, Inc.) and its subsidiaries unless specifically stated otherwise or the context otherwise indicates. The following defines certain of the commonly used terms in this annual report on Form 10-K: MBS refers to mortgage-backed securities; Agency MBS refers to MBS that are issued or guaranteed by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. government, such as Ginnie Mae; Senior MBS refers to non-Agency MBS that represent the senior most tranches, which have the highest priority to cash flows from the related collateral pool, within the MBS structure; Hybrids refer to hybrid mortgage loans that have interest rates that are fixed for a specified period of time and, thereafter, generally adjust annually to an increment over a specified interest rate index; ARMs refer to Hybrids and adjustable-rate mortgage loans which typically have interest rates that adjust annually to an increment over a specified interest rate index; and ARM-MBS refers to MBS that are secured by ARMs.

PART I

Item 1. Business.

GENERAL

We are a real estate investment trust (or REIT) primarily engaged in the business of investing, on a leveraged basis, in ARM-MBS, which are secured by pools of residential mortgages. Our ARM-MBS portfolio consists primarily of Agency MBS and Senior MBS. Our principal business objective is to generate net income for distribution to our stockholders resulting from the difference between the interest and other income we earn on our investments and the interest expense we pay on the borrowings that we use to finance our investments and our operating costs.

At December 31, 2008, we had total assets of approximately \$10.641 billion, of which \$10.123 billion, or 95.1%, represented our MBS portfolio. At December 31, 2008, \$9.919 billion, or 98.0%, of our MBS portfolio was comprised of Agency MBS, \$203.6 million, or 2.0%, was comprised of Senior MBS and \$376,000, or less than one-tenth of one percent, was comprised of other non-Agency MBS.

We were incorporated in Maryland on July 24, 1997 and began operations on April 10, 1998. We have elected to be taxed as a REIT for U.S. federal income tax purposes. One of the requirements of maintaining our qualification as a REIT is that we must distribute at least 90% of our annual REIT taxable income to our stockholders. Effective January 1, 2009, we changed our name from MFA Mortgage Investments, Inc. to MFA Financial, Inc.

INVESTMENT STRATEGY

We are primarily engaged in the business of investing in Agency ARM-MBS and other high quality ARM-MBS. Our operating policies require that at least 50% of our investment portfolio consist of ARM-MBS that are either (i) Agency MBS or (ii) rated in one of the two highest rating categories by at least one of a nationally recognized rating agency, such as Moody's Investors Services, Inc. (or Moody's), Standard & Poor's Corporation (or S&P) or Fitch, Inc. (or Rating Agencies). Pursuant to our operating policies, the remainder of our assets may consist of direct or indirect investments in: (i) other types of MBS; (ii) residential mortgage loans; (iii) collateralized debt obligations and other related securities; (iv) real estate; (v) securities issued by REITs, limited partnerships and closed-end funds; (vi) high-yield corporate securities and other fixed income instruments (corporate or government); and (vii) other types of assets approved by our Board of Directors (or Board) or a committee thereof.

At December 31, 2008, our MBS portfolio was comprised entirely of ARM-MBS. The ARMs collateralizing our MBS include Hybrids, with initial fixed-rate periods generally ranging from three to ten years, and, to a lesser extent, adjustable-rate mortgages. Interest rates on the mortgage loans collateralizing our MBS are based on specific index

rates, such as London Interbank Offered Rate (or LIBOR), the one-year constant maturity treasury (or CMT) rate, the Federal Reserve U.S. 12-month cumulative average one-year CMT (or MTA) or the 11th District Cost of Funds Index (or COFI). In addition, the ARMs collateralizing our MBS typically have interim and lifetime caps on interest rate adjustments.

Because the coupons earned on ARM-MBS adjust over time as interest rates change (typically after an initial fixed-rate period) the market values of these assets are generally less sensitive to changes in interest rates than are fixed-rate MBS. In order to mitigate our interest rate risks, our strategy is to maintain a substantial majority of our portfolio in ARM-MBS. At December 31, 2008, ARM-MBS comprised 95.1% of our total assets and 100% of our total MBS portfolio. The ability of ARM-MBS to reset over time based on changes in certain benchmark interest rates helps to mitigate interest rate risk more effectively over a longer time period than over the short term; however, interest rate risk is not entirely eliminated.

FINANCING STRATEGY

Our financing strategy is designed to increase the size of our MBS portfolio by borrowing against a substantial portion of the market value of the MBS in our portfolio. We typically utilize repurchase agreements to finance the acquisition of our MBS and, in certain cases, enter into interest rate swap agreements (or Swaps) to hedge the interest rate risk associated with a portion of our short-term repurchase agreements. At December 31, 2008, we had \$9.039 billion outstanding under repurchase agreements, of which \$3.670 billion was hedged with active Swaps. At December 31, 2008, our debt-to-equity ratio was 7.2 to 1.

Repurchase agreements are financing contracts (i.e., borrowings) under which we pledge our MBS as collateral to secure loans with repurchase agreement counterparties (i.e., lenders). The amount borrowed under a repurchase agreement is limited to a specified percentage of the fair value of the pledged collateral. The portion of the pledged collateral held by the lender is the margin requirement for that borrowing. Repurchase agreements take the form of a sale of the pledged collateral to a lender at an agreed upon price in return for such lender's simultaneous agreement to resell the same securities back to the borrower at a future date (i.e., the maturity of the borrowing) at a higher price. The difference between the sale price and repurchase price is the cost, or interest expense, of borrowing under a repurchase agreement. Our cost of borrowings under repurchase agreements generally corresponds to LIBOR plus or minus a margin. Under our repurchase agreements, we retain beneficial ownership of the pledged collateral, while the lender maintains custody of such collateral. At the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral or, with the consent of the lender, we may renew such agreement at the then prevailing market interest rate. Under our repurchase agreements, a lender may require that we pledge additional assets to such lender, by initiating a margin call, if the fair value of our existing pledged collateral declines below a required margin amount during the term of the borrowing. Our pledged collateral fluctuates in value primarily due to principal payments and changes in market value, which may be impacted by changes in market interest rates, prevailing market yields and other market conditions. By maintaining low leverage levels relative to the margin requirements on our repurchase agreements, we are better able to respond to potential increases in margin requirements. To date, we have satisfied all of our margin calls and have never sold assets to meet any margin calls.

In order to reduce our exposure to counterparty-related risk, we generally seek to diversify our exposure by entering into repurchase agreements with multiple counterparties with a maximum loan from any lender of no more than three times our stockholders' equity. At December 31, 2008, we had outstanding balances under repurchase agreements with 19 separate lenders with a maximum net exposure (the difference between the amount loaned to us, including interest payable, and the value of the securities pledged by us as collateral, including accrued interest receivable on such securities) to any single lender of \$139.7 million. In addition, we also enter into Swaps with certain of our repurchase agreement counterparties and other institutions. At December 31, 2008, our aggregate maximum net exposure to any single counterparty for repurchase agreements and Swaps was \$221.7 million.

We enter into derivative financial instruments (or Hedging Instruments) to hedge against increases in interest rates on a portion of our anticipated LIBOR-based repurchase agreements. At December 31, 2008, our Hedging Instruments consisted solely of Swaps, which are used to lock-in fixed interest rates, over the term of the Swap, related to a portion of our existing and anticipated future repurchase agreements. At December 31, 2008, we were a party to 127 fixed-pay Swaps with an aggregate notional amount of \$3.970 billion, which included two forward-starting Swaps totaling \$300.0 million. Historically, we also purchased interest rate cap agreements (or Caps) to hedge our interest rate risk. A Cap is a contract whereby we, as the purchaser, pay a fee in exchange for the right to receive payments equal to the principal (i.e., notional amount) times the difference between a specified interest rate and a future interest rate during a defined "active" period of time. Under our Caps, if the 30-day LIBOR were to increase above the interest rate specified in each Cap during the effective term of such Cap, we would be entitled to receive monthly payments from the counterparty to such Cap during the period that the 30-day LIBOR exceeded such specified interest rate. While we have not purchased any Caps since 2004, we may do so in the future. We do not anticipate entering into any Hedging Instruments for speculative or trading purposes.

In addition to repurchase agreements and subject to maintaining our qualification as a REIT, we may also use other sources of funding in the future to finance our MBS portfolio, including, but not limited to, other types of collateralized borrowings, loan agreements, lines of credit, commercial paper or the issuance of debt securities.

OTHER INVESTMENTS AND ADVISORY BUSINESS

In November 2008, we formed MFResidential Assets I, LLC (or MFR LLC) as a wholly-owned subsidiary to opportunistically invest in Senior MBS. We expect that MFR LLC will allow us to build a track record in the Senior MBS sector and help us to grow our future asset management business. At December 31, 2008, \$204.0 million, or 2.0%, of our MBS portfolio, including \$14.5 million of assets held through MFR LLC, was invested in non-Agency MBS, of which \$203.6 million were Senior MBS.

Through a wholly-owned subsidiary, we provide investment advisory services to a third-party institution with respect to its Agency MBS portfolio investments that totaled approximately \$172.1 million at December 31, 2008.

At December 31, 2008, we had an indirect investment of \$11.3 million in a 191-unit multi-family apartment property. The long-term fixed-rate mortgage loan collateralized by this property is non-recourse, subject to customary non-recourse exceptions. At December 31, 2008, the mortgage secured by this multi-family apartment property, which matures on February 1, 2011, had a balance of \$9.3 million. (See Note 6 to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

We continue to explore alternative business strategies, investments and financing sources and other initiatives to complement our core business strategy. However, no assurance can be provided that any such strategic initiatives will or will not be implemented in the future or, if undertaken, that any such strategic initiative will favorably impact us.

CORPORATE GOVERNANCE

We strive to maintain an ethical workplace in which the highest standards of professional conduct are practiced.

- Our Board is composed of a majority of independent directors. Our Audit, Nominating and Corporate Governance and Compensation Committees are composed exclusively of independent directors.
- In order to foster the highest standards of ethics and conduct in all of our business relationships, we have adopted a Code of Business Conduct and Ethics and Corporate Governance Guidelines, which cover a wide range of business practices and procedures that apply to all of our directors, officers and employees. In addition, we have implemented Whistle Blowing Procedures for Accounting and Auditing Matters that set forth procedures by which any officer or employee may raise, on a confidential basis, concerns regarding any questionable or unethical accounting, internal accounting controls or auditing matters with our Audit Committee.
- We have an insider trading policy that prohibits any of our directors, officers or employees from buying or selling our common and preferred stock on the basis of material nonpublic information and prohibits communicating material nonpublic information to others.
- We have a formal internal audit function to further the effective functioning of our internal controls and procedures. Our internal audit plan, which is approved annually by our Audit Committee, is based on a formal risk assessment and is intended to provide management and our Audit Committee with an effective tool to identify and address areas of financial or operational concerns and to ensure that appropriate controls and procedures are in place. We have implemented Section 404 of the

Sarbanes-Oxley Act of 2002, as amended (or the SOX Act), which requires an evaluation of internal control over financial reporting in association with our financial statements for the year ending December 31, 2008. (See Item 9A, "Controls and Procedures" included in this annual report on Form 10-K.)

COMPETITION

We operate in the mortgage-REIT industry. We believe that our principal competitors in the business of acquiring and holding MBS of the types in which we invest are financial institutions, such as banks, savings and loan institutions, life insurance companies, institutional investors, including mutual funds and pension funds, hedge funds and other mortgage-REITs. Some of these entities may not be subject to the same regulatory constraints (i.e., REIT compliance or maintaining an exemption under the Investment Company Act of 1940, as amended (or the Investment Company Act)) as us. In addition, many of these entities have greater financial resources and access to capital than us. The existence of these entities, as well as the possibility of additional entities forming in the future, may increase the competition for the acquisition of MBS, resulting in higher prices and lower yields on such assets.

EMPLOYEES

At December 31, 2008, we had 22 employees, all of whom were full-time. We believe that our relationship with our employees is good. None of our employees is unionized or represented under a collective bargaining agreement.

AVAILABLE INFORMATION

We maintain a website at www.mfa-reit.com. We make available, free of charge, on our website our (a) annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K (including any amendments thereto), proxy statements and other information (or collectively, the Company Documents) filed with, or furnished to, the Securities and Exchange Commission (or SEC), as soon as reasonably practicable after such documents are so filed or furnished, (b) Corporate Governance Guidelines, (c) Code of Business Conduct and Ethics and (d) written charters of the Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee of our Board. Our Company Documents filed with, or furnished to, the SEC are also available at the SEC's website at www.sec.gov. We also provide copies of our Corporate Governance Guidelines and Code of Business Conduct and Ethics, free of charge, to stockholders who request it. Requests should be directed to Timothy W. Korth, General Counsel, Senior Vice President – Business Development and Corporate Secretary, at MFA Financial, Inc., 350 Park Avenue, 21st floor, New York, New York 10022.

Item 1A. Risk Factors.

Our business and operations are subject to a number of risks and uncertainties, the occurrence of which could adversely affect our business, financial condition, results of operations and ability to make distributions to stockholders and could cause the value of our capital stock to decline.

General.

Our business and operations are affected by a number of factors, many of which are beyond our control, and primarily depend on, among other things, the level of our net interest income, the market value of our assets, the supply of, and demand for, MBS in the market place and the availability of acceptable financing. Our net interest income varies primarily as a result of changes in interest rates, the slope of the yield curve (i.e., the differential between long-term and short-term interest rates), borrowing costs (i.e., interest expense) and prepayment speeds on our MBS portfolio, the behavior of which involves various risks and uncertainties. Interest rates and prepayment speeds, as measured by the constant prepayment rate (or CPR), vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty.

Our operating results also depend upon our ability to effectively manage the risks associated with our business operations, including interest rate, prepayment, financing and credit risks, while maintaining our qualification as a REIT. In addition to our Agency MBS, we face risks inherent in our other assets, comprised of Senior MBS, other non-Agency MBS and an indirect 100% interest in a multi-family apartment property. Although these other assets represent a small portion of our total assets, 2.0% at December 31, 2008, they have the potential of materially impacting our operating performance in future periods if such assets were to become impaired.

Risks Associated With Recent Adverse Developments in the Mortgage Finance and Credit Markets

Volatile market conditions for mortgages and mortgage-related assets as well as the broader financial markets have resulted in a significant contraction in liquidity for mortgages and mortgage-related assets, which may adversely affect the value of the assets in which we invest.

Our results of operations are materially affected by conditions in the markets for mortgages and mortgage-related assets, including MBS, as well as the broader financial markets and the economy generally. Beginning in the summer of 2007, significant adverse changes in financial market conditions have resulted in a deleveraging of the entire global financial system and the forced sale of large quantities of mortgage-related and other financial assets. Recently, concerns over economic recession, geopolitical issues, unemployment, the availability and cost of financing, the mortgage market and a declining real estate market have contributed to increased volatility and diminished expectations for the economy and markets. As a result of these conditions, many traditional mortgage investors have suffered severe losses in their residential mortgage portfolios and several major market participants have failed or been impaired, resulting in a significant contraction in market liquidity for mortgage-related assets. This illiquidity has negatively affected both the terms and availability of financing for all mortgage-related assets. Further increased volatility and deterioration in the markets for mortgages and mortgage-related assets as well as the broader financial markets may adversely affect the performance and market value of our investment securities. If these conditions persist, institutions from which we seek financing for our investments may continue to tighten their lending standards or become insolvent, which could make it more difficult for us to obtain financing on favorable terms or at all. Our profitability may be adversely affected if we are unable to obtain cost-effective financing for our investments.

The federal conservatorship of Fannie Mae and Freddie Mac and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the U.S. Government, may adversely affect our business.

The payments of principal and interest we receive on our Agency MBS, which depend directly upon payments on the ARMs underlying such securities, are guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. Fannie Mae and Freddie Mac are U.S. Government-sponsored entities (or GSEs), but their guarantees are not backed by the full faith and credit of the United States. Ginnie Mae is part of a U.S. Government agency and its guarantees are backed by the full faith and credit of the United States.

In response to general market instability and, more specifically, the financial conditions of Fannie Mae and Freddie Mac, on July 30, 2008, the Housing and Economic Recovery Act of 2008 (or the HERA) established a new regulator for Fannie Mae and Freddie Mac, the U.S. Federal Housing Finance Agency (or the FHFA). On September 7, 2008, the U.S. Treasury, the FHFA, and the U.S. Federal Reserve announced a comprehensive action plan to help stabilize the financial markets, support the availability of mortgage finance and protect taxpayers. Under this plan, among other things, the FHFA has been appointed as conservator of both Fannie Mae and Freddie Mac, allowing the FHFA to control the actions of the two GSEs, without forcing them to liquidate, which would be the case under receivership. Importantly, the primary focus of the plan is to increase the availability of mortgage financing by allowing these GSEs to continue to grow their guarantee business without limit, while limiting net purchases of Agency MBS to a modest amount through the end of 2009. Beginning in 2010, these GSEs will gradually reduce their Agency MBS portfolios.

In addition, in an effort to further stabilize the U.S. mortgage market, the U.S. Treasury took three additional actions. First, it entered into a preferred stock purchase agreement with each of the GSEs, pursuant to which \$100 billion will be available to each GSE. Second, it established a new secured credit facility, available to each of Fannie Mae and Freddie Mac (as well as Federal Home Loan Banks) through December 31, 2009, when other funding sources are unavailable. Third, it established an Agency MBS purchase program, under which the U.S. Treasury may purchase Agency MBS in the open market. This Agency MBS purchase program will also expire on December 31, 2009. Initially, Fannie Mae and Freddie Mac each issued \$1.0 billion of senior preferred stock to the U.S. Treasury and warrants to purchase 79.9% of the fully-diluted common stock outstanding of each GSE at a nominal exercise price. Pursuant to these agreements, each of Fannie Mae's and Freddie Mac's mortgage and Agency MBS portfolio may not exceed \$850 billion as of December 31, 2009, and will decline by 10% each year until such portfolio reaches \$250 billion. After reporting a substantial loss in the third quarter of 2008, Freddie Mac requested a capital injection of \$13.8 billion by the U.S. Treasury pursuant to its preferred stock purchase agreement.

Although the U.S. Government has committed capital to Fannie Mae and Freddie Mac, there can be no assurance that these actions will be adequate for their needs. These uncertainties lead to questions about the future of the GSEs in their current form, or at all, and the availability of, and trading market for, Agency MBS. Despite the steps taken by the U.S. Government, Fannie Mae and Freddie Mac could default on their guarantee obligations which would materially and adversely affect the value of our Agency MBS. Accordingly, if these government actions are inadequate and the GSEs continue to suffer losses or cease to exist, our business, operations and financial condition could be materially and adversely affected.

Additionally, the size and timing of the U.S. Government's Agency MBS purchase program is subject to the discretion of the Secretary of the U.S. Treasury, who has indicated that the scale of the program will be based on developments in the capital markets and housing markets. Purchases under this program have already begun, but there is no certainty that the U.S. Treasury will continue to purchase additional Agency MBS in the future. The U.S. Treasury can hold its portfolio of Agency MBS to maturity and, based on mortgage market conditions, may make adjustments to the portfolio. This flexibility may adversely affect the pricing and availability of Agency MBS in the market. It is also possible that the U.S. Treasury's commitment to purchase Agency MBS in the future could create additional demand that would negatively affect the pricing of the Agency MBS that we seek to acquire.

The U.S. Treasury could also stop providing credit support to Fannie Mae and Freddie Mac in the future. The U.S. Treasury's authority to purchase Agency MBS and to provide financial support to Fannie Mae and Freddie Mac under the HERA expires on December 31, 2009. The problems faced by Fannie Mae and Freddie Mac resulting in their being placed into federal conservatorship have stirred debate among some federal policy makers regarding the continued role of the U.S. Government in providing liquidity for mortgage loans. Following expiration of the current authorization, each of Fannie Mae and Freddie Mac could be dissolved and the U.S. Government could determine to stop providing liquidity support of any kind to the mortgage market. The future roles of Fannie Mae and Freddie Mac could be significantly reduced and the nature of their guarantee obligations could be considerably limited relative to

historical measurements. Any changes to the nature of their guarantee obligations could redefine what constitutes an Agency MBS and could have broad adverse implications for the market and our business, operations and financial condition. If Fannie Mae or Freddie Mac were eliminated, or their structures were to change radically (i.e., limitation or removal of the guarantee obligation), we may be unable to acquire additional Agency MBS and our existing Agency MBS could be materially and adversely impacted.

We could be negatively affected in a number of ways depending on the manner in which related events unfold for Fannie Mae and Freddie Mac. We rely on our Agency MBS as collateral for our financings under our repurchase agreements. Any decline in their value, or perceived market uncertainty about their value, would make it more difficult for us to obtain financing on acceptable terms or at all, or to maintain our compliance with the terms of any financing transactions. Further, the current credit support provided by the U.S. Treasury to Fannie Mae and Freddie Mac, and any additional credit support it may provide in the future, could have the effect of lowering the interest rates we expect to receive from Agency MBS, thereby tightening the spread between the interest we earn on our Agency MBS and the cost of financing those assets. A reduction in the supply of Agency MBS could also negatively affect the pricing of Agency MBS by reducing the spread between the interest we earn on our portfolio of Agency MBS and our cost of financing that portfolio.

As indicated above, recent legislation has changed the relationship between Fannie Mae and Freddie Mac and the U.S. Government and requires Fannie Mae and Freddie Mac to reduce the amount of mortgage loans they own or for which they provide guarantees on Agency MBS. Future legislation could further change the relationship between Fannie Mae and Freddie Mac and the U.S. Government, and could also nationalize or eliminate such entities entirely. Any law affecting these GSEs may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae or Freddie Mac. As a result, such laws could increase the risk of loss on investments in Agency MBS guaranteed by Fannie Mae and/or Freddie Mac. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially and adversely affect our business, operations and financial condition.

There can be no assurance that the actions taken by the U.S. and foreign governments, central banks and other governmental and regulatory bodies for the purpose of seeking to stabilize the financial markets will achieve the intended effect or benefit our business and further government or market developments could adversely affect us.

In response to the financial issues affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, the Emergency Economic Stabilization Act of 2008 (or EESA), was enacted by the U.S. Congress. The EESA provides the Secretary of the U.S. Treasury with the authority to establish a Troubled Asset Relief Program (or TARP) to purchase from financial institutions up to \$700 billion of residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008. In addition, under TARP, the U.S. Treasury, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, may purchase any other financial instrument deemed necessary to promote financial market stability, upon transmittal of such determination, in writing, to the appropriate committees of the U.S. Congress. EESA also provides for a program that would allow companies to insure their troubled assets.

In November 2008, after using a significant portion of the funds available under TARP to make preferred equity investments in certain financial institutions, the Secretary of the U.S. Treasury announced that following enactment of EESA, the U.S. Treasury had continued to examine the relative benefits of purchasing illiquid mortgage-related assets and had determined that its assessment at that time was that such purchases were not the most effective way to use limited TARP funds. However, the U.S. Treasury will continue to examine whether targeted forms of asset purchase can play a useful role, relative to other potential uses of TARP resources.

On November 25, 2008, the Federal Reserve announced that it would initiate a program to purchase \$100 billion in direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and \$500 billion in Agency MBS. The Federal Reserve stated that its actions are intended to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally. The purchases of direct obligations began during the first week of December 2008 and purchases of residential MBS began on January 5, 2009.

There can be no assurance that the EESA or the Federal Reserve's actions will have a beneficial impact on the financial markets. To the extent the markets do not respond favorably to TARP or TARP does not function as intended, our business may not receive the anticipated positive impact from the legislation and such result may have broad adverse market implications. In addition, U.S. and foreign governments, central banks and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. We cannot predict whether or when such actions may occur or what affect, if any, such actions could have on our business, results of operations and financial condition.

Mortgage loan modification programs and future legislative action may adversely affect the value of, and the returns, on our MBS.

The U.S. Government, through the Federal Housing Authority and the Federal Deposit Insurance Corporation (or FDIC) commenced implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. These programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans or the rate of interest payable on the loans, or to extend the payment terms of the loans. In addition, members of the U.S. Congress have indicated support for additional legislative relief for homeowners, including an amendment of the bankruptcy laws to permit the modification of mortgage loans in bankruptcy proceedings. These loan modification programs, as well as future legislative or regulatory actions, including amendments to the bankruptcy laws, that result in the modification of outstanding mortgage loans may adversely affect the value of, and the returns on, our MBS.

Prepayment rates on the mortgage loans underlying our MBS may adversely affect our profitability.

The MBS that we acquire are primarily secured by pools of ARMs on residential properties. In general, the ARMs collateralizing our MBS may be prepaid at any time without penalty. Prepayments on our MBS result when homeowners/mortgagees satisfy (i.e., payoff) the mortgage upon selling or refinancing their mortgaged property. In addition, because our MBS are primarily Agency MBS, defaults and foreclosures typically have the same effect as prepayments because of the underlying agency guarantee. When we acquire a particular MBS, we anticipate that the underlying mortgage loans will prepay at a projected rate which provides us with an expected yield on such MBS. When mortgagees prepay their mortgage loans faster than anticipated, it results in a faster prepayment rate on the related MBS in our portfolio, which may adversely affect our profitability. Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayment rates also may be affected by conditions in the housing and financial markets, general economic conditions and the relative interest rates on fixed-rate mortgage loans and ARMs.

We often purchase MBS that have a higher interest rate than the prevailing market interest rate. In exchange for a higher interest rate, we typically pay a premium over par value to acquire these securities. In accordance with generally accepted accounting principles (or GAAP), we amortize the premiums on our MBS over the life of the related MBS. If the mortgage loans securing our MBS prepay at a rapid rate, we will have to amortize our premiums on an accelerated basis which may adversely affect our profitability. As of December 31, 2008, we had net purchase premiums of \$125.0 million, or 1.3% of current par value, on our Agency MBS and net purchase discounts of \$11.7 million, or 3.4% of current par value, on our non-Agency MBS.

Prepayments, which are the primary feature of MBS that distinguish them from other types of bonds, are difficult to predict and can vary significantly over time. As the holder of MBS, on a monthly basis, we receive a payment equal to a portion of our investment principal in a particular MBS as the underlying mortgages are prepaid. With respect to our Agency MBS, we typically receive notice of monthly principal prepayments on the fifth business day of each month (such day is commonly referred to as factor day) and receive the related scheduled payment on a specified later date, which for (a) Agency MBS guaranteed by Fannie Mae is the 25th day of that month (or next business day thereafter), (b) Agency MBS guaranteed by Freddie Mac is the 15th day of the following month (or next business day thereafter), and (c) Agency MBS guaranteed by Ginnie Mae is the 20th day of that month (or next business day thereafter). With respect to our non-Agency MBS, we typically receive notice of monthly principal prepayments and the related scheduled payment on the 25th day of each month (or next business day thereafter). In general, on the date each month that principal prepayments are announced (i.e., factor day for Agency MBS), the value of our MBS pledged as collateral under our repurchase agreements is reduced by the amount of the prepaid principal and, as a result, our lenders will typically initiate a margin call requiring the pledge of additional collateral or cash, in an

amount equal to such prepaid principal, in order to re-establish the required ratio of borrowing to collateral value under such repurchase agreements. Accordingly, with respect to our Agency MBS, the announcement on factor day of principal prepayments is in advance of our receipt of the related scheduled payment, thereby creating a short-term receivable for us in the amount of any such principal prepayments; however, under our repurchase agreements, we may receive a margin call relating to the related reduction in value of our Agency MBS and, prior to receipt of this short-term receivable, be required to post collateral or cash in the amount of the principal prepayment on or about factor day, which would reduce our liquidity during the period in which the short-term receivable was outstanding. As a result, in order to meet any such margin calls, we could be forced to sell assets in order to maintain liquidity. Forced sales under adverse market conditions may result in lower sales prices than ordinary market sales made in the normal course of business. If our MBS were liquidated at prices below our amortized cost (i.e., the carrying value) of such assets, we would incur losses, which could adversely affect our earnings. In addition, in order to continue to earn a return on this prepaid principal, we must reinvest it in additional MBS or other assets; however, if interest rates decline, we may earn a lower return on our new investments as compared to the MBS that prepay.

Prepayments may have a negative impact on our financial results, the effects of which depends on, among other things, the timing and amount of the prepayment delay on our Agency MBS, the amount of unamortized premium on our prepaid MBS, the reinvestment lag and the availability of suitable reinvestment opportunities.

Our business strategy involves a significant amount of leverage which may adversely affect our return on our investments and may reduce cash available for distribution to our stockholders as well as increase losses when economic conditions are unfavorable.

Pursuant to our leverage strategy, we borrow against a substantial portion of the market value of our MBS and use the borrowed funds to finance the acquisition of additional investment assets. We are not required to maintain any particular assets-to-equity ratio. Future increases in the amount by which the collateral value is required to contractually exceed the repurchase transaction loan amount, decreases in the market value of our MBS, increases in interest rate volatility and changes in the availability of acceptable financing could cause us to be unable to achieve the degree of leverage we believe to be optimal. Our return on our assets and cash available for distribution to our stockholders may be reduced to the extent that changes in market conditions prevent us from leveraging our investments or cause the cost of our financing to increase relative to the income earned on our leveraged assets. In addition, our payment of interest expense on our borrowings will reduce cash flow available for distributions to our stockholders. If the interest income on our MBS purchased with borrowed funds fails to cover the interest expense of the related borrowings, we will experience net interest losses and may experience net losses from operations. Such losses could be significant as a result of our leveraged structure. The use of borrowing, or “leverage,” to finance our MBS and other assets involves a number of other risks, including the following:

• Adverse developments involving major financial institutions or involving one of our lenders could result in a rapid reduction in our ability to borrow and adversely affect our business and profitability. Although as of December 31, 2008 we had amounts outstanding under repurchase agreements with 19 separate lenders and continue to develop new relationships with additional lenders, recent turmoil in the financial markets as it relates to major financial institutions has raised concerns that a material adverse development involving one or more major financial institutions or the financial markets in general could result in our lenders reducing our access to funds available under our repurchase agreements. Dramatic declines in the housing market, with decreasing home prices and increasing foreclosures and unemployment, have resulted in significant asset write-downs by financial institutions, which have caused many financial institutions to seek additional capital, to merge with other institutions and, in some cases, to fail. Institutions from which we seek to obtain financing may have owned or financed residential mortgage loans, real estate-related securities and real estate loans which have declined in value and caused losses as a result of the recent downturn in the markets. Many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers, including other financial institutions. If these conditions persist, these institutions may become insolvent or tighten their lending standards, which could make it more difficult for us to obtain acceptable financing or at all. Because all of our repurchase agreements are uncommitted and renewable at the discretion of our lenders, these conditions could cause our lenders to determine to reduce or terminate our access to future borrowings, which could adversely affect our business and profitability. Furthermore, if a number of our lenders became unwilling or unable to continue to provide us with financing, we could be forced to sell assets, including MBS in an unrealized loss position, in order to maintain liquidity. Forced sales under adverse market conditions may result in lower sales prices than ordinary market sales made in the normal course of business. If our MBS were liquidated at prices below our amortized cost (i.e., the carrying value) of such assets, we would incur losses, which could adversely affect our earnings.

Our profitability may be limited by a reduction in our leverage. As long as we earn a positive spread between interest and other income we earn on our assets and our borrowing costs, we can generally increase our profitability by using greater amounts of leverage. We cannot, however, assure you that repurchase financing will remain an efficient source of long-term financing for our assets. The amount of leverage that we use may be limited because our lenders might not make funding available to us at acceptable rates or they may require that we provide additional collateral to secure our borrowings. If our financing strategy is not viable, we will have to find alternative forms of financing for our assets which may not be available to us on acceptable terms or at acceptable rates. In addition, in response to certain interest rate and investment environments or to changes in market liquidity, we could adopt a strategy of reducing our leverage by selling assets or not reinvesting principal payments as MBS amortize and/or prepay, thereby decreasing the outstanding amount of our related borrowings. Such an action could reduce interest income, interest expense and net income, the extent of which would be dependent on the level of reduction in assets and liabilities as well as the sale prices for which the assets were sold.

If we are unable to renew our borrowings at favorable rates, it may force us to sell assets and our profitability may be adversely affected. Since we rely primarily on borrowings under repurchase agreements to finance our MBS, our ability to achieve our investment objectives depends on our ability to borrow funds in sufficient amounts and on favorable terms and on our ability to renew or replace maturing borrowings on a continuous basis. Our repurchase agreement credit lines are renewable at the discretion of our lenders and, as such, do not contain guaranteed roll-over terms. Our ability to enter into repurchase transactions in the future will depend on the market value of our MBS pledged to secure the specific borrowings, the availability of acceptable financing and market liquidity and other conditions existing in the lending market at that time. If we are not able to renew or replace maturing borrowings, we could be forced to sell assets, including MBS in an unrealized loss position, in order to maintain liquidity. Forced sales under adverse market conditions may result in lower sales prices than ordinary market sales made in the normal course of business. If our MBS were liquidated at prices below our amortized cost (i.e., the carrying value) of such assets, we would incur losses, which could adversely affect our earnings.

A decline in the market value of our assets may result in margin calls that may force us to sell assets under adverse market conditions. In general, the market value of our MBS is impacted by changes in interest rates, prevailing market yields and other market conditions. A decline in the market value of our MBS may limit our ability to borrow against such assets or result in lenders initiating margin calls, which require a pledge of additional collateral or cash to re-establish the required ratio of borrowing to collateral value, under our repurchase agreements. Posting additional collateral or cash to support our credit will reduce our liquidity and limit our ability to leverage our assets, which could adversely affect our business. As a result, we could be forced to sell some of our assets, including MBS in an unrealized loss position, in order to maintain liquidity. Forced sales under adverse market conditions may result in lower sales prices than ordinary market sales made in the normal course of business. If our MBS were liquidated at prices below our amortized cost (i.e., the carrying value) of such assets, we would incur losses, which could adversely affect our earnings.

If a counterparty to our repurchase transactions defaults on its obligation to resell the underlying security back to us at the end of the transaction term or if we default on our obligations under the repurchase agreement, we could incur losses. When we engage in repurchase transactions, we generally sell securities to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities (this difference is referred to as the haircut), if the lender defaults on its obligation to resell the same securities back to us we would incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the securities). Further, if we default on one of our obligations under a repurchase transaction, the lender can elect to terminate the transaction and cease entering into additional repurchase transactions with us. Our repurchase agreements may also contain cross-default provisions, so that if a default occurs under any one agreement, the lenders under our other repurchase agreements could also declare a default. Any losses we incur on our repurchase transactions could adversely affect

our earnings and thus our cash available for distribution to our stockholders.

Our use of repurchase agreements to borrow money may give our lenders greater rights in the event of bankruptcy. Borrowings made under repurchase agreements may qualify for special treatment under the U.S. Bankruptcy Code. If a lender under one of our repurchase agreements files for bankruptcy, it may be difficult for us to recover our assets pledged as collateral to such lender. In addition, if we ever file for bankruptcy, lenders under our repurchase agreements may be able to avoid the automatic stay provisions of the Bankruptcy Code and take possession of, and liquidate, our collateral under our repurchase agreements without delay.

We have experienced declines in the market value of our assets.

A decline in the market value of our MBS or other assets may require us to recognize an “other-than-temporary” impairment against such assets under GAAP if we were to determine that, with respect to any assets in unrealized loss positions, we do not have the ability and intent to hold such assets for a period of time sufficient to allow for recovery (which may be at maturity) of the amortized cost of such assets. If such a determination were made, we would recognize unrealized losses through earnings and write down the amortized cost of such assets to a new cost basis, based on the fair market value of such assets on the date they are considered to be other-than-temporarily impaired. Such impairment charges reflect non-cash losses at the time of recognition. Any subsequent disposition or sale of such impaired assets could further affect our future losses or gains, as they are based on the difference between the sale price received and adjusted amortized cost of such assets at the time of sale. In the past, we have experienced declines in the market value of our MBS and other assets which were determined to be other-than-temporary. As a result, we recognized other-than-temporary impairments against such assets under GAAP, which were recognized through earnings, reflecting the write down of the cost basis of such assets to their fair market value at the point the determination was made.

Our investment strategy may involve credit risk.

The holder of a mortgage or MBS assumes a risk that the borrowers may default on their obligations to make full and timely payments of principal and interest. Our investment policy requires that at least 50% of our assets consist of MBS that are either (a) issued or guaranteed by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae, or (b) are rated in one of the two highest rating categories by at least one of the Rating Agencies. Even though we have acquired primarily Agency MBS to date, pursuant to our investment policy, we have the ability to acquire non-Agency MBS and other investment assets of lower credit quality. At December 31, 2008, we owned non-Agency MBS with a fair value of \$204.0 million (and an amortized cost of \$332.9 million), of which \$203.6 million was comprised of Senior MBS and \$376,000 was comprised of other non-Agency MBS. In general, non-Agency MBS, including Senior MBS, carry greater investment risk than Agency MBS because they are not guaranteed as to principal and/or interest by the U.S. Government, any federal agency or any federally chartered corporation. Unexpectedly high rates of default (e.g., in excess of the default rates forecasted) and/or higher loss severities on the mortgages collateralizing our non-Agency MBS may adversely affect the value of such assets. Accordingly, non-Agency MBS and other investment assets of lower credit quality could cause us to incur losses of income from, and/or losses in market value relating to, these assets if there are defaults of principal and/or interest on, or if the Rating Agencies downgrade the credit rating of, these assets.

An increase in our borrowing costs relative to the interest we receive on our MBS may adversely affect our profitability.

Our earnings are primarily generated from the difference between the interest income we earn on our investment portfolio, less net amortization of purchase premiums and discounts, and the interest expense we pay on our borrowings. We rely primarily on borrowings under repurchase agreements, with terms ranging from one to 48 months (with the majority of such borrowings, at December 31, 2008, having terms of one to three months), to finance the acquisition of MBS which have longer-term contractual maturities. Even though most of our MBS have interest rates that adjust over time based on short-term changes in corresponding interest rate indexes, the interest we pay on our borrowings may increase at a faster pace than the interest we earn on our MBS. In general, if the interest expense on our borrowings increases relative to the interest income we earn on our MBS, our profitability may be adversely affected.

Changes in interest rates, cyclical or otherwise, may adversely affect our profitability. Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and

political conditions, as well as other factors beyond our control. In general, we finance the acquisition of our MBS through borrowings in the form of repurchase transactions, which exposes us to interest rate risk on the financed assets. The cost of our borrowings is based on prevailing market interest rates. Because the terms of our repurchase transactions range from one to 48 months at inception (with the majority of such transactions, at December 31, 2008, having terms of one to three months), the interest rates on our borrowings generally adjust more frequently (as new repurchase transactions are entered into upon the maturity of existing repurchase transactions) than the interest rates on our MBS. During a period of rising interest rates, our borrowing costs generally will increase at a faster pace than our interest earnings on the leveraged portion of our MBS portfolio, which could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition, including the impact of hedging transactions, at the time as well as the magnitude and period over which interest rates increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our MBS portfolio. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which may negatively impact our distributions to stockholders.

Hybrid MBS have fixed interest rates for an initial period which may reduce our profitability if short-term interest rates increase. The ARMs collateralizing our MBS are primarily comprised of Hybrids, which have interest rates that are fixed for an initial period (typically three to ten years) and, thereafter, generally adjust annually to an increment over a pre-determined interest rate index. Accordingly, during a period of rising interest rates, the cost of our borrowings (excluding the impact of hedging transactions) would increase while the interest income earned on our MBS portfolio would not increase with respect to those Hybrid MBS that were then in their initial fixed rate period. If this were to happen, we could experience a decrease in net income or incur a net loss during these periods, which may negatively impact our distributions to stockholders.

Interest rate caps on the ARMs collateralizing our MBS may adversely affect our profitability if short-term interest rates increase. The coupons earned on ARM-MBS adjust over time as interest rates change (typically after an initial fixed-rate period). The financial markets primarily determine the interest rates that we pay on the repurchase transactions used to finance the acquisition of our MBS; however, the level of adjustment to the interest rates earned on our ARM-MBS is typically limited by contract. The interim and lifetime interest rate caps on the ARMs collateralizing our MBS limit the amount by which the interest rates on such assets can adjust. Interim interest rate caps limit the amount interest rates on a particular ARM can adjust during any given year or period. Lifetime interest rate caps limit the amount interest rates can adjust from inception through maturity of a particular ARM. Our repurchase transactions are not subject to similar restrictions. Accordingly, in a sustained period of rising interest rates or a period in which interest rates rise rapidly, we could experience a decrease in net income or a net loss because the interest rates paid by us on our borrowings (excluding the impact of hedging transactions) could increase without limitation (as new repurchase transactions are entered into upon the maturity of existing repurchase transactions) while increases in the interest rates earned on the ARMs collateralizing our MBS could be limited due to interim or lifetime interest rate caps.

Adjustments of interest rates on our borrowings may not be matched to interest rate indexes on our MBS. In general, the interest rates on our repurchase transactions are based on LIBOR, while the interest rates on our ARM-MBS may be indexed to LIBOR or another index rate, such as the one-year CMT rate, MTA or COFI. Accordingly, any increase in LIBOR relative to one-year CMT rates, MTA or COFI will generally result in an increase in our borrowing costs that is not matched by a corresponding increase in the interest earned on our ARM-MBS. Any such interest rate index mismatch could adversely affect our profitability, which may negatively impact our distributions to stockholders.

A flat or inverted yield curve may adversely affect ARM-MBS prepayment rates and supply. Our net interest income varies primarily as a result of changes in interest rates as well as changes in interest rates across the yield curve. When the differential between short-term and long-term benchmark interest rates narrows, the yield curve is said to be “flattening.” We believe that when the yield curve is relatively flat, borrowers have an incentive to refinance into Hybrids with longer initial fixed-rate periods and fixed rate mortgages, causing our MBS to experience faster prepayments. In addition, a flatter yield curve generally leads to fixed-rate mortgage rates that are closer to the interest rates available on ARMs, potentially decreasing the supply of ARM-MBS. At times, short-term interest rates may increase and exceed long-term interest rates, causing an inverted yield curve. When the yield curve is inverted, fixed-rate mortgage rates may approach or be lower than mortgage rates on ARMs, further increasing ARM-MBS prepayments and further negatively impacting ARM-MBS supply. Increases in prepayments on our MBS portfolio cause our premium amortization to accelerate, lowering the yield on such assets. If this happens, we could experience a decrease in net income or incur a net loss during these periods, which may negatively impact our distributions to stockholders.

Our use of hedging strategies to mitigate our interest rate exposure may not be effective and may expose us to counterparty risks.

In accordance with our operating policies, we may pursue various types of hedging strategies, including Swaps, Caps and other derivative transactions, to seek to mitigate or reduce our exposure to losses from adverse changes in interest rates. Our hedging activity will vary in scope based on the level and volatility of interest rates, the type of assets held and financing sources used and other changing market conditions. No hedging strategy, however, can completely insulate us from the interest rate risks to which we are exposed and there is no guarantee that the implementation of any hedging strategy would have the desired impact on our results of operations or financial condition. Certain of the U.S. federal income tax requirements that we must satisfy in order to qualify as a REIT may limit our ability to hedge against such risks. We will not enter into derivative transactions if we believe that they will jeopardize our qualification as a REIT.

Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- interest rate hedging can be expensive, particularly during periods of rising and volatile interest rates;
- available interest rate hedges may not correspond directly with the interest rate risk for which protection is sought;
 - the duration of the hedge may not match the duration of the related liability;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
 - the party owing money in the hedging transaction may default on its obligation to pay.

We primarily use Swaps to hedge against future increases in interest rates on our repurchase agreements. Should a Swap counterparty be unable to make required payments pursuant to such Swap, the hedged liability would cease to be hedged for the remaining term of the Swap. In addition, we may be at risk for any collateral held by a hedging counterparty to a Swap, should such counterparty become insolvent or file for bankruptcy. In September 2008, Lehman Brothers Holdings Inc. (or Lehman), the parent guarantor of Lehman Brother Special Financing Inc. (or LBSF), one of our Swap counterparties, filed for bankruptcy protection. As a result of the bankruptcy filing by Lehman, we terminated our two outstanding Swaps with LBSF, realizing a loss of \$986,000, comprised of an \$841,000 loss on the termination of the Swaps at market value and a \$145,000 write-off against an unsecured receivable from LBSF. Our hedging transactions, which are intended to limit losses, may actually adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.

Hedging Instruments involve risk since they often are not traded on regulated exchanges, guaranteed by an exchange or its clearing house, or regulated by any U.S. or foreign governmental authorities. Consequently, there are no requirements with respect to record keeping, financial responsibility or segregation of customer funds and positions. Furthermore, the enforceability of Hedging Instruments may depend on compliance with applicable statutory and commodity and other regulatory requirements and, depending on the identity of the counterparty, applicable international requirements. The business failure of a hedging counterparty with whom we enter into a hedging transaction will most likely result in its default. Default by a party with whom we enter into a hedging transaction may result in a loss and force us to cover our commitments, if any, at the then current market price. Although generally we will seek to reserve the right to terminate our hedging positions, it may not always be possible to dispose of or close out a hedging position without the consent of the hedging counterparty and we may not be able to enter into an offsetting contract in order to cover our risk. We cannot assure you that a liquid secondary market will exist for hedging instruments purchased or sold, and we may be required to maintain a position until

exercise or expiration, which could result in losses.

We may enter into Hedging Instruments that could expose us to contingent liabilities in the future.

Subject to maintaining our qualification as a REIT, part of our financing strategy will involve entering into Hedging Instruments that could require us to fund cash payments in certain circumstances (e.g., the early termination of a Hedging Instrument caused by an event of default or other voluntary or involuntary termination event or the decision by a hedging counterparty to request the posting of collateral it is contractually owed under the terms of a Hedging Instrument). With respect to the termination of an existing Swap, the amount due would generally be equal to the unrealized loss of the open Swap position with the hedging counterparty and could also include other fees and charges. These economic losses will be reflected in our financial results of operations and our ability to fund these obligations will depend on the liquidity of our assets and access to capital at the time. Any losses we incur on our Hedging Instruments could adversely affect our earnings and thus our cash available for distribution to our stockholders.

We may change our investment strategy, operating policies and/or asset allocations without stockholder consent.

We may change our investment strategy, operating policies and/or asset allocation with respect to investments, acquisitions, leverage, growth, operations, indebtedness, capitalization and distributions at any time without the consent of our stockholders. A change in our investment strategy may increase our exposure to interest rate and/or credit risk, default risk and real estate market fluctuations. Furthermore, a change in our asset allocation could result in our making investments in asset categories different from our historical investments. These changes could adversely affect our financial condition, results of operations, the market price of our common stock or our ability to pay dividends or make distributions.

We have not established a minimum dividend payment level.

We intend to pay dividends on our common stock in an amount equal to at least 90% of our REIT taxable income, which is calculated generally before the dividends paid deduction and excluding net capital income, in order to maintain our qualification as a REIT for U.S. federal income tax purposes. Dividends will be declared and paid at the discretion of our Board and will depend on our REIT taxable earnings, our financial condition, maintenance of our REIT qualification and such other factors as our Board may deem relevant from time to time. We have not established a minimum dividend payment level for our common stock and our ability to pay dividends may be negatively impacted by adverse changes in our operating results.

We are dependent on our executive officers and key personnel for our success.

As a self-advised REIT, our success is dependent upon the efforts, experience, diligence, skill and network of business contacts of our executive officers and key personnel. The departure of any of our executive officers and/or key personnel could have a material adverse effect on our operations and performance.

We are dependent on information systems and systems' failures could significantly disrupt our business.

Our business is highly dependent on our communications and information systems. Any failure or interruption of our systems could cause delays or other problems in our securities trading activities, which could have a material adverse effect on our operation and performance.

We may be subject to risks associated with our investment in real estate.

Real property investments are subject to varying degrees of risk. The economic returns from our indirect investment in Lealand Place, a 191-unit multi-family apartment property located in Lawrenceville, Georgia (or Lealand), may be impacted by a number of factors, including general and local economic conditions, the relative supply of apartments and other housing in the area, interest rates on mortgage loans, the need for and costs of repairs and maintenance of the property, government regulations and the cost of complying with them, taxes and inflation. In general, local conditions in the applicable market area significantly affect occupancy or rental rates for multi-family apartment properties. Real estate investments are relatively illiquid and, therefore, we will have limited ability to dispose of our investment quickly in response to changes in economic or other conditions. In addition, under certain circumstances, we may be subject to significant tax liability in the event that we sell our investment in the property. Under various federal, state and local environmental laws, regulations and ordinances, we may be required, regardless of knowledge or responsibility, to investigate and remediate the effects of hazardous or toxic substances or petroleum product releases at the property and may be held liable to a governmental entity or to third parties for property or personal injury damages and for investigation and remediation costs incurred as a result of contamination. These damages and costs may be substantial. The presence of such substances, or the failure to properly remediate the contamination, may adversely affect our ability to borrow against, sell or rent the affected property. We must operate the property in compliance with numerous federal, state and local laws and regulations, including landlord tenant laws, the Americans

with Disabilities Act of 1990 and other laws generally applicable to business operations. Noncompliance with such laws could expose us to liability.

We operate in a highly competitive market for investment opportunities and competition may limit our ability to acquire desirable investment securities.

We operate in a highly competitive market for investment opportunities. Our profitability depends, in large part, on our ability to acquire MBS or other investment securities at favorable prices. In acquiring our investment securities, we compete with a variety of institutional investors, including other REITs, public and private funds, commercial and investment banks, commercial finance and insurance companies and other financial institutions. Many of our competitors are substantially larger and have considerably greater financial, technical, marketing and other resources than we do. Some competitors may have a lower cost of funds and access to funding sources that are not available to us. Many of our competitors are not subject to the operating constraints associated with REIT compliance or maintenance of an exemption from the Investment Company Act. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish additional business relationships than us. Furthermore, government or regulatory action and competition for investment securities of the types and classes which we acquire may lead to the price of such assets increasing, which may further limit our ability to generate desired returns. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, desirable investments may be limited in the future and we may not be able to take advantage of attractive investment opportunities from time to time, as we can provide no assurance that we will be able to identify and make investments that are consistent with our investment objectives.

Our qualification as a REIT.

We have elected to qualify as a REIT and intend to comply with the provisions of the Internal Revenue Code of 1986, as amended (or the Code). Accordingly, we will not be subjected to income tax to the extent we distribute our REIT taxable income (which is generally ordinary income, computed by excluding the dividends paid deduction, income from prohibited transactions, income from foreclosure property and any net capital income) to stockholders and provided that we comply with certain income, asset and ownership tests applicable to REITs. We believe that we currently meet all of the REIT requirements and, therefore, continue to qualify as a REIT under the provisions of the Code. Many of the REIT requirements, however, are highly technical and complex. The determination that we are a REIT requires an analysis of various factual matters and circumstances, some of which may not be totally within our control and some of which involve interpretation. For example, as set forth in the REIT tax laws, to qualify as a REIT, annually at least 75% of our gross income must come from, among other sources, interest on obligations secured by mortgages on real property or interests in real property, gain from the disposition of non-dealer real property, including mortgages or interest in real property, dividends, other distributions and gains from the disposition of shares in other REITs, commitment fees received for agreements to make real estate loans and certain temporary investment income. In addition, the composition of our assets must meet certain requirements at the close of each quarter. There can be no assurance that the Internal Revenue Service (or IRS) or a court would agree with any conclusions or positions we have taken in interpreting the REIT requirements. Also in order to maintain our qualification as a REIT, we must distribute at least 90% of our REIT taxable income on an annual basis to our stockholders. Such dividend distribution requirement limits the amount of cash we have available for other business purposes, including amounts to fund our growth. Also, it is possible that because of differences in timing between the recognition of taxable income and the actual receipt of cash, we may have to borrow funds on a short-term basis to meet the 90% dividend distribution requirement. Even a technical or inadvertent mistake could jeopardize our REIT qualification unless we meet certain statutory relief provisions. Furthermore, Congress and the IRS might make changes to the tax laws and regulations, and the courts might issue new rulings, that make it more difficult or impossible for us to remain qualified as a REIT.

If we fail to qualify as a REIT in any taxable year, and we do not qualify for certain statutory relief provisions, we would be required to pay U.S. federal income tax on our taxable income, and distributions to our stockholders would

not be deductible by us in determining our taxable income. In such a case, we might need to borrow money or sell assets in order to pay our taxes. Our payment of income tax would decrease the amount of our income available for distribution to our stockholders. Furthermore, if we fail to maintain our qualification as a REIT, we no longer would be required to distribute substantially all of our taxable income to our stockholders. In addition, unless we were eligible for certain statutory relief provisions, we could not re-elect to qualify as a REIT until the fifth calendar year following the year in which we failed to qualify.

Even if we qualify as a REIT for U.S. federal income tax purposes, we may be required to pay certain federal, state and local taxes on our income. Any of these taxes will reduce our operating cash flow.

Compliance with securities laws and regulations could be costly.

The SOX Act and the rules and regulations promulgated by the SEC and the New York Stock Exchange affect the scope, complexity and cost of corporate governance, regulatory compliance and reporting, and disclosure practices. We believe that these rules and regulations will continue to make it costly for us to obtain director and officer liability insurance and we may be required to accept reduced coverage or incur substantially higher costs to obtain the same coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified members of management and our Board (particularly with respect to Board members serving on our Audit Committee).

In addition, our management is required to deliver a report that assesses the effectiveness of our internal controls over financial reporting, pursuant to Section 302 of the SOX Act. Section 404 of the SOX Act requires our independent registered public accounting firm to deliver an attestation report on management's assessment of, and the operating effectiveness of, our internal controls over financial reporting in conjunction with their opinion on our audited financial statements as of each December 31. We cannot give any assurances that material weaknesses will not be identified in the future in connection with our compliance with the provisions of Sections 302 and 404 of the SOX Act. The existence of any such material weakness would preclude a conclusion by management and our independent auditors that we maintained effective internal control over financial reporting. Our management may be required to devote significant time and expense to remediate any material weaknesses that may be discovered and may not be able to remediate any material weaknesses in a timely manner. The existence of any material weakness in our internal control over financial reporting could also result in errors in our financial statements that could require us to restate our financial statements, cause us to fail to meet our reporting obligations and cause stockholders to lose confidence in our reported financial information, all of which could lead to a decline in the market price of our capital stock.

Loss of our Investment Company Act exemption would adversely affect us.

We intend to conduct our business so as to maintain our exempt status under, and not to become regulated as an investment company for purposes of, the Investment Company Act. If we failed to maintain our exempt status under the Investment Company Act and became regulated as an investment company, our ability to, among other things, use leverage would be substantially reduced and, as a result, we would be unable to conduct our business as described in this annual report on Form 10-K. The Investment Company Act exempts entities that are "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" (i.e., qualifying interests). Under the current interpretations of the staff of the SEC, in order to qualify for this exemption, we must maintain (i) at least 55% of our assets in qualifying interests (or the 55% Test) and (ii) at least 80% of our assets in real estate related assets (including qualifying interests) (or the 80% Test). MBS that do not represent all of the certificates issued (i.e., an undivided interest) with respect to the entire pool of mortgages (i.e., a whole pool) underlying such MBS may be treated as securities separate from such underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% Test; however, such MBS would be considered real estate related assets for purposes of the 80% Test. Therefore, for purposes of the 55% Test, our ownership of these types of MBS is limited by the provisions of the Investment Company Act. In meeting the 55% Test, we treat as qualifying interests those MBS issued with respect to an underlying pool as to which we own all of the issued certificates. There can be no assurance that the laws and regulations governing REITs, including the Division of Investment Management of the SEC providing more specific or different guidance regarding the treatment of assets as qualifying interests or real estate related assets, will not change in a manner that adversely affects our operations. If the SEC or its staff were to adopt a contrary interpretation, we could be required to sell a substantial amount of our investment securities under potentially adverse market conditions. Further, in order to insure that we at all times qualify for this exemption from the Investment Company Act, we may be precluded from acquiring MBS whose yield is higher than the yield on MBS that could be otherwise purchased in a manner consistent with this exemption. Accordingly, we monitor our compliance with both of the 55% Test and the 80% Test in order to maintain our exempt status under the Investment

Company Act; however, there can be no assurance that we will be able to maintain our exemption as an investment company under the Investment Company Act. If we fail to qualify for this exception in the future, we could be required to restructure our activities, including effecting sales of our investment securities under potentially adverse market conditions, which could negatively affect the value of our common stock, the sustainability of our business model and our ability to make distributions. As of December 31, 2008, we had determined that we were in compliance, and had maintained such compliance during the year then ended, with both of the 55% Test and the 80% Test.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Executive Offices

We have a lease for our corporate headquarters in New York, New York which extends through April 30, 2017 and provides for aggregate cash payments ranging over time from approximately \$1.1 million to \$1.4 million per year, paid on a monthly basis, exclusive of escalation charges and landlord incentives. In connection with this lease, we established a \$350,000 irrevocable standby letter of credit in lieu of lease security through April 30, 2017. The letter of credit may be drawn upon by the landlord in the event that we default under certain terms of the lease. In addition, we have a lease through December 2011 for our off-site back-up facility located in Rockville Centre, New York, which provides for, among other things, rent of approximately \$29,000 per year, paid on a monthly basis. We believe that our current facilities are adequate to meet our needs in the foreseeable future.

Properties Owned Through Subsidiary Corporations

At December 31, 2008, we indirectly owned 100% interest in Lealand, an apartment property located at 2945 Cruse Road, Lawrenceville, Georgia. (See Note 6 to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

Item 3. Legal Proceedings.

None.

To date, we have not been required to make any payments to the IRS as a penalty for failing to make disclosures required with respect to certain transactions that have been identified by the IRS as abusive or that have a significant tax avoidance purpose.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 4A. Executive Officers.

The following table sets forth certain information with respect to each of our executive officers at December 31, 2008. The Board appoints or annually reaffirms the appointment of all of our executive officers:

| Officer | Age | Position Held |
|----------------------|-----|---|
| Stewart Zimmerman | 64 | Chairman of the Board and Chief Executive Officer |
| William S. Gorin | 50 | President and Chief Financial Officer |
| Ronald A. Freydberg | 48 | Executive Vice President and Chief Investment Officer |
| Teresa D. Covello | 43 | Senior Vice President, Chief Accounting Officer and Treasurer |
| Timothy W. Korth | 43 | General Counsel, Senior Vice President – Business Development and Corporate Secretary |
| Craig L. Knutson | 49 | Senior Vice President – Investments |
| Kathleen A. Hanrahan | 43 | Senior Vice President – Accounting |

Stewart Zimmerman has served as our Chief Executive Officer and a Director since 1997 and was appointed Chairman of the Board in March 2003. From 1997 through 2008, Mr. Zimmerman also served as our President. From 1989 through 1997, he initially served as a consultant to The America First Companies and became Executive Vice President of America First Companies, L.L.C. During this time, he held a number of positions: President and Chief Operating Officer of America First REIT, Inc. and President of several mortgage funds, including America First Participating/Preferred Equity Mortgage Fund, America First PREP Fund 2, America First PREP Fund II Pension Series L.P., Capital Source L.P., Capital Source II L.P.-A, America First Tax Exempt Mortgage Fund Limited Partnership and America First Tax Exempt Fund 2-Limited Partnership. Previously, Mr. Zimmerman held various progressive positions with other companies, including Security Pacific Merchant Bank, EF Hutton & Company, Inc., Lehman Brothers, Bankers Trust Company and Zenith Mortgage Company. Mr. Zimmerman holds a Bachelors of Arts degree from Michigan State University.

William S. Gorin serves as our President and Chief Financial Officer. He served as Executive Vice President from 1997 through his appointment as our President during 2008, and has been our Chief Financial Officer since 2001. Mr. Gorin has also served as our Secretary and Treasurer. From 1989 to 1997, Mr. Gorin held various positions with PaineWebber Incorporated/Kidder, Peabody & Co. Incorporated, serving as a First Vice President in the Research Department. Prior to that position, Mr. Gorin was Senior Vice President in the Special Products Group. From 1982 to 1988, Mr. Gorin was employed by Shearson Lehman Hutton, Inc./E.F. Hutton & Company, Inc. in various positions in corporate finance and direct investments. Mr. Gorin has a Masters of Business Administration degree from Stanford University and a Bachelor of Arts degree in Economics from Brandeis University.

Ronald A. Freydberg serves as our Executive Vice President and Chief Investment Officer. He served as Executive Vice President and Chief Portfolio Officer from 2001 through his appointment as Chief Investment Officer during 2008. From 1997 to 2001, he served as our Senior Vice President. From 1995 to 1997, Mr. Freydberg served as a Vice President of Pentalpha Capital, in Greenwich, Connecticut, where he was a fixed-income quantitative analysis and structuring specialist. From 1988 to 1995, Mr. Freydberg held various positions with J.P. Morgan & Co. From 1994 to 1995, he was with the Global Markets Group. In that position, he was involved in commercial mortgage-backed securitization and sale of distressed commercial real estate, including structuring, due diligence and marketing. From 1985 to 1988, Mr. Freydberg was employed by Citicorp. Mr. Freydberg holds a Masters of

Business Administration degree in Finance from George Washington University and a Bachelor of Arts degree from Muhlenberg College.

Teresa D. Covello serves as our Senior Vice President, Chief Accounting Officer and Treasurer, which positions she was appointed to in 2003. From 2001 to 2003, Ms. Covello served as our Senior Vice President and Controller. From 2000 until joining us in 2001, Ms. Covello was a self-employed financial consultant, concentrating in investment banking within the financial services sector. From 1990 to 2000, she was the Director of Financial Reporting and served on the Strategic Planning Team for JSB Financial, Inc. Ms. Covello began her career in public accounting with KPMG Peat Marwick (predecessor to KPMG LLP). She currently serves as a director and president of the board of directors of Commerce Plaza, Inc., a not-for-profit organization. Ms. Covello is a Certified Public Accountant and has a Bachelor of Science degree in Public Accounting from Hofstra University.

Timothy W. Korth II serves as our General Counsel, Senior Vice President – Business Development and Corporate Secretary, which positions he has held since July 2003. From 2001 to 2003, Mr. Korth was a Counsel at the law firm of Clifford Chance US LLP, where he specialized in corporate and securities transactions involving REITs and other real estate companies and, prior to such time, had practiced law with that firm and its predecessor, Rogers & Wells LLP, since 1992. Mr. Korth is admitted as an attorney in the State of New York and has a Juris Doctor and a Bachelor of Business Administration degree in Finance from the University of Notre Dame.

Craig L. Knutson serves as our Senior Vice President, which position he has held since March 2008. From 2004 to 2007, Mr. Knutson served as Senior Executive Vice President of CBA Commercial, LLC, an acquirer and securitizer of small balance commercial mortgages. From 2001 to 2004, Mr. Knutson served as President and Chief Operating Officer of ARIASYS Inc. From 1986 to 1999, Mr. Knutson held various progressive positions in the mortgage trading departments of First Boston Corporation (later Credit Suisse), Smith Barney and Morgan Stanley. In these capacities, Mr. Knutson traded agency and private label MBS as well as whole loans (unsecuritized mortgages). From 1981 to 1984, Mr. Knutson served as an Analyst and then Associate in the Investment Banking Department of E.F. Hutton & Company Inc. Mr. Knutson holds a Masters of Business Administration degree from Harvard University and a Bachelor of Arts degree in Economics and French from Hamilton College.

Kathleen A. Hanrahan serves as our Senior Vice President – Accounting, which position she was appointed to in May 2008. From 2007 until joining us in 2008, Ms. Hanrahan was Vice President – Financial Reporting with Arbor Commercial Mortgage LLC. From 1997 to 2006, she was the First Vice President of Financial Reporting and served on the Disclosure, Corporate Benefits and Sarbanes-Oxley Committees for Independence Community Bank Corp. From 1992 – 1997, Ms. Hanrahan held various positions, including Controller, with North Side Savings Bank. Ms. Hanrahan began her career in public accounting with KPMG Peat Marwick (predecessor to KPMG LLP). Ms. Hanrahan is a Certified Public Accountant and has a Bachelor of Business Administration degree in Public Accounting from Pace University.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market Information

Our common stock is listed on the New York Stock Exchange, under the symbol "MFA." On February 11, 2009, the last sales price for our common stock on the New York Stock Exchange was \$5.78 per share. The following table sets forth the high and low sales prices per share of our common stock during each calendar quarter for the years ended December 31, 2008 and 2007:

| Quarter Ended | 2008 | | 2007 | |
|---------------|----------|---------|---------|---------|
| | High | Low | High | Low |
| March 31 | \$ 11.07 | \$ 5.00 | \$ 7.87 | \$ 6.75 |
| June 30 | \$ 7.47 | \$ 6.10 | \$ 8.06 | \$ 6.90 |
| September 30 | \$ 7.70 | \$ 5.24 | \$ 8.65 | \$ 5.55 |
| December 31 | \$ 6.36 | \$ 3.98 | \$ 9.30 | \$ 7.61 |

Holders

As of February 10, 2009, we had 850 registered holders and approximately 25,423 beneficial owners of our common stock. Such information was obtained through our registrar and transfer agent, based on the results of a broker search.

Dividends

No dividends may be paid on our common stock unless full cumulative dividends have been paid on our 8.50% Series A Cumulative Redeemable preferred stock, par value \$0.01 per share. From the date of our original issuance in April 2004 through December 31, 2008, we have paid full cumulative dividends on our preferred stock on a quarterly basis.

We have historically declared cash dividends on our common stock on a quarterly basis. During 2008 and 2007, we declared total cash dividends to holders of our common stock of \$158.5 million (\$0.81 per share) and \$42.2 million (\$0.415 per share), respectively. In general, our common stock dividends have been characterized as ordinary income to our stockholders for income tax purposes. However, a portion of our common stock dividends may, from time to time, be characterized as capital gains or return of capital. For 2008 and 2007, our common stock dividends were characterized as ordinary income to stockholders. (For additional dividend information, see Notes 10(a) and 10(b) to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

We elected to be taxed as a REIT for U.S. federal income tax purposes commencing with our taxable year ended December 31, 1998 and, as such, have distributed and anticipate distributing annually at least 90% of our REIT taxable income. Although we may borrow funds to make distributions, cash for such distributions has generally been, and is expected to continue to be, largely generated from our results of our operations.

We declared and paid the following dividends on our common stock during the years 2008 and 2007:

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| Year | Declaration Date | Record Date | Payment Date | Dividend per Share |
|------|-------------------|-------------------|------------------|-----------------------|
| 2008 | April 1, 2008 | April 14, 2008 | April 30, 2008 | \$ 0.180 |
| | July 1, 2008 | July 14, 2008 | July 31, 2008 | 0.200 |
| | October 1, 2008 | October 14, 2008 | October 31, 2008 | 0.220 |
| | December 11, 2008 | December 31, 2008 | January 30, 2009 | 0.210 (1) |
| 2007 | April 3, 2007 | April 13, 2007 | April 30, 2007 | \$ 0.080 |
| | July 2, 2007 | July 13, 2007 | July 31, 2007 | 0.090 |
| | October 1, 2007 | October 12, 2007 | October 31, 2007 | 0.100 |
| | December 13, 2007 | December 31, 2007 | January 31, 2008 | 0.145 (1) |

(1) For tax purposes, a portion of each of the dividends declared on December 11, 2008 and December 13, 2007 was treated as a dividend for stockholders in the subsequent year.

Dividends are declared and paid at the discretion of our Board and depend on our cash available for distribution, financial condition, ability to maintain our qualification as a REIT, and such other factors that our Board may deem relevant. We have not established a minimum payout level for our common stock. See Item 1A, “Risk Factors”, and Item 7, “Management’s Discussion and Analysis of Financial Conditions and Results of Operations”, of this annual report on Form 10-K, for information regarding the sources of funds used for dividends and for a discussion of factors, if any, which may adversely affect our ability to pay dividends at the same levels in 2009 and thereafter.

Discount Waiver, Direct Stock Purchase and Dividend Reinvestment Plan

In September 2003, we initiated a Discount Waiver, Direct Stock Purchase and Dividend Reinvestment Plan (or the DRSP) to provide existing stockholders and new investors with a convenient and economical way to purchase shares of our common stock. Under the DRSP, existing stockholders may elect to automatically reinvest all or a portion of their cash dividends in additional shares of our common stock and existing stockholders and new investors may make optional monthly cash purchases of shares of our common stock in amounts ranging from \$50 (or \$1,000 for new investors) to \$10,000 and, with our prior approval, in excess of \$10,000. At our discretion, we may issue shares of our common stock under the DRSP at discounts of up to 5% from the prevailing market price at the time of purchase. The Bank of New York Mellon is the administrator of the DRSP (or the Plan Agent). Stockholders who own common stock that is registered in their own name and want to participate in the DRSP must deliver a completed enrollment form to the Plan Agent. Stockholders who own common stock that is registered in a name other than their own (e.g., broker, bank or other nominee) and want to participate in the DRSP must either request such nominee holder to participate on their behalf or request that such nominee holder re-register our common stock in the stockholder’s name and deliver a completed enrollment form to the Plan Agent. Additional information regarding the DRSP (including a DRSP prospectus) and enrollment forms are available online from the Plan Agent via Investor Service Direct at www.bnymellon.com/shareowner/isd or from our website at www.mfa-reit.com. During 2008, we sold 965,398 shares of common stock through the DRSP generating net proceeds of \$5.6 million.

Controlled Equity Offering Program

On August 20, 2004, we initiated a controlled equity offering program (or the CEO Program) through which we may, from time to time, publicly offer and sell shares of our common stock through Cantor Fitzgerald & Co. (or Cantor) in privately negotiated and/or at-the-market transactions. During 2008, we issued 20,834,000 shares of common stock in at-the-market transactions through our CEO Program, raising net proceeds of \$127,009,685 and, in connection with these transactions, we paid Cantor fees and commissions of \$2,592,035.

Securities Authorized For Issuance Under Equity Compensation Plans

During 2004, we adopted the 2004 Equity Compensation Plan (or the 2004 Plan), as approved by our stockholders. During 2008, the 2004 Plan was amended by the Board to bring it into compliance with Section 409A of the Code. The 2004 Plan amended and restated our Second Amended and Restated 1997 Stock Option Plan. (For a description of the 2004 Plan, see Note 13(a) to the consolidated financial statements included under Item 8 of this annual report on Form 10-K.)

The following table presents certain information about our equity compensation plans as of December 31, 2008:

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding |
|---------------|--|---|---|
|---------------|--|---|---|

| | and rights | | securities reflected in the first column of this table) |
|---|----------------|----------------|---|
| Equity compensation plans approved by stockholders | 632,000 | \$ 9.31 | 1,582,689 |
| Equity compensation plans not approved by stockholders | - | - | - |
| Total | 632,000 | \$ 9.31 | 1,582,689 |

Item 6. Selected Financial Data.

Our selected financial data set forth below should be read in conjunction with our consolidated financial statements and the accompanying notes, included under Item 8 of this annual report on Form 10-K.

| | At or For the Year Ended December 31, | | | | |
|---|---------------------------------------|--------------|--------------|--------------|--------------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| (In Thousands, Except per Share Amounts) | | | | | |
| Operating Data: | | | | | |
| Interest and dividend income on investment securities | \$ 519,788 | \$ 380,328 | \$ 216,871 | \$ 235,798 | \$ 174,957 |
| Interest income on cash and cash equivalent investments | 7,729 | 4,493 | 2,321 | 2,921 | 807 |
| Interest expense | (342,688) | (321,305) | (181,922) | (183,833) | (88,888) |
| Net (loss)/gain on sale of investment securities (1) | (24,530) | (21,793) | (23,113) | (18,354) | 371 |
| Loss on termination of Swaps, net (2) | (92,467) | (384) | - | - | - |
| Other-than-temporary impairments (3) | (5,051) | - | - | (20,720) | - |
| Other income (4) | 1,901 | 2,060 | 2,264 | 1,811 | 1,675 |
| Operating and other expense | (18,885) | (13,446) | (11,185) | (10,829) | (10,622) |
| Income from continuing operations | 45,797 | 29,953 | 5,236 | 6,794 | 78,300 |
| Discontinued operations, net | - | 257 | 3,522 | (86) | (227) |
| Net income | \$ 45,797 | \$ 30,210 | \$ 8,758 | \$ 6,708 | \$ 78,073 |
| Preferred stock dividends | 8,160 | 8,160 | 8,160 | 8,160 | 3,576 |
| Net income/(loss) to common stockholders | \$ 37,637 | \$ 22,050 | \$ 598 | \$ (1,452) | \$ 74,497 |
| Income/(loss) per common share from continuing operations – basic and diluted | \$ 0.21 | \$ 0.24 | \$ (0.03) | \$ (0.02) | \$ 0.98 |
| Income per common share from discontinued operations – basic and diluted | \$ - | \$ - | \$ 0.04 | \$ - | \$ - |
| Income/(loss) per common share – basic and diluted | \$ 0.21 | \$ 0.24 | \$ 0.01 | \$ (0.02) | \$ 0.98 |
| Dividends declared per share of common stock (5) | \$ 0.810 | \$ 0.415 | \$ 0.210 | \$ 0.405 | \$ 0.960 |
| Dividends declared per share of preferred stock | \$ 2.125 | \$ 2.125 | \$ 2.125 | \$ 2.125 | \$ 1.440 |
| Balance Sheet Data: | | | | | |
| Investment securities | \$ 10,122,583 | \$ 8,302,797 | \$ 6,340,668 | \$ 5,714,906 | \$ 6,777,574 |
| Total assets | 10,641,419 | 8,605,859 | 6,443,967 | 5,846,917 | 6,913,684 |
| Repurchase agreements | 9,038,836 | 7,526,014 | 5,722,711 | 5,099,532 | 6,113,032 |
| Preferred stock, liquidation preference (6) | 96,000 | 96,000 | 96,000 | 96,000 | 96,000 |
| Total stockholders' equity | 1,257,077 | 927,263 | 678,558 | 661,102 | 728,834 |

(1)2008: In response to tightening of market credit conditions in the first quarter, we adjusted our balance sheet strategy, decreasing our target debt-to-equity multiple range from 8x to 9x to 7x to 9x. In order to implement this strategy, we reduced our borrowings, by selling MBS with an amortized cost of \$1.876 billion, realizing aggregate net losses of \$24.5 million, comprised of gross losses of \$25.1 million and gross gains of \$571,000. 2007: We selectively sold \$844.5 million of Agency and AAA rated MBS, realizing a net loss of \$21.8 million. 2006 and 2005: Beginning in the fourth quarter of 2005 through the second quarter of 2006, we reduced our asset base through a strategy under which we, among other things, sold our higher duration and lower yielding MBS. During 2006, we sold approximately \$1.844 billion of MBS, realizing net losses of \$23.1 million, comprised of gross losses of \$25.2 million and gross gains of \$2.1 million. For 2005, the repositioning involved the sale of \$564.8 million of MBS, which resulted in an \$18.4 million loss on sale. (See Note (3) below.)

- (2) In March 2008, we terminated 48 Swaps with an aggregate notional amount of \$1.637 billion, realizing losses of \$91.5 million. In connection with the termination of these Swaps, we repaid the repurchase agreements that such Swaps hedged. (See Note (1), above). In addition, during 2008, we recognized losses of \$986,000 in connection with two Swaps terminated in response to the Lehman bankruptcy in September 2008.
- (3) 2008: We recognized other-than-temporary impairment charges of \$5.1 million, of which \$4.9 million reflected a full write-off of two unrated investment securities and \$183,000 was an impairment charge against one non-Agency MBS that was rated BB. 2005: As part of the repositioning of our MBS portfolio, at December 31, 2005 we determined that we no longer had the intent to continue to hold certain MBS that were in an unrealized loss position. As a result, we recognized other-than-temporary impairment charges of \$20.7 million against 30 MBS with an amortized cost of \$842.2 million. The subsequent sale of these securities during 2006 resulted in a gain/recovery of \$1.6 million.
- (4) Results of operations for real estate sold have been reclassified to discontinued operations for 2005 and 2004.
- (5) We generally declare dividends on our common stock in the month subsequent to the end of each calendar quarter, with the exception of the fourth quarter dividend which is typically declared during the fourth calendar quarter for tax purposes.
- (6) Reflects the aggregate liquidation preference on the 3,840,000 outstanding shares of our 8.50% Series A Cumulative Redeemable Preferred Stock, par value \$0.01. Our Preferred Stock is redeemable exclusively at our option at \$25.00 per share plus accrued interest and unpaid dividends (whether or not declared) commencing on April 27, 2009. No dividends may be paid on our common stock unless full cumulative dividends have been paid on our Preferred Stock. From the date of our original issuance in April 2004 through December 31, 2008, we have paid full quarterly dividends on our Preferred Stock.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with our financial statements and accompanying notes included in Item 8 of this annual report on Form 10-K.

GENERAL

Effective January 1, 2009, we changed our name to MFA Financial, Inc., from MFA Mortgage Investments, Inc.

At December 31, 2008, we had total assets of \$10.641 billion, of which \$10.123 billion, or 95.1%, represented our MBS portfolio. Included in our MBS portfolio were Agency MBS of \$9.919 billion, Senior MBS of \$203.6 million and other non-Agency MBS of \$376,000. The remainder of our investment-related assets were primarily comprised of cash and cash equivalents, restricted cash, MBS-related receivables, securities held as collateral and an investment in a multi-family apartment property. Through wholly-owned subsidiaries, we also provide third-party investment advisory services.

Our principal business objective is to generate net income for distribution to our stockholders resulting from the difference between the interest and other income we earn on our investments and the interest expense we pay on the borrowings that we use to finance our investments and our operating costs.

The results of our business operations are affected by a number of factors, many of which are beyond our control, and primarily depend on, among other things, the level of our net interest income, the market value of our assets, the supply of, and demand for, MBS in the market place and the availability of adequate financing. Our net interest income varies primarily as a result of changes in interest rates, the slope of the yield curve (i.e., the differential between long-term and short-term interest rates), borrowing costs (i.e., our interest expense) and prepayment speeds on our MBS portfolio, the behavior of which involves various risks and uncertainties. Interest rates and prepayment speeds, as measured by the CPR, vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty.

With respect to our business operations, increases in interest rates, in general, may over time cause: (i) the interest expense associated with our repurchase agreement borrowings to increase; (ii) the value of our MBS portfolio and, correspondingly, our stockholders' equity to decline; (iii) coupons on our MBS to reset, although on a delayed basis, to higher interest rates; (iv) prepayments on our MBS portfolio to slow, thereby slowing the amortization of our MBS purchase premiums; and (v) the value of our Swaps and, correspondingly, our stockholders' equity to increase. Conversely, decreases in interest rates, in general, may over time cause: (i) prepayments on our MBS portfolio to increase, thereby accelerating the amortization of our MBS purchase premiums; (ii) the interest expense associated with our repurchase agreements to decrease; (iii) the value of our MBS portfolio and, correspondingly, our stockholders' equity to increase; (iv) the value of our Swaps and, correspondingly, our stockholders' equity to decrease, and (v) coupons on our MBS assets to reset, although on a delayed basis, to lower interest rates. In addition, our borrowing costs and credit lines are further affected by the type of collateral pledged and general conditions in the credit market.

In general, we expect that over time ARM-MBS will prepay faster than fixed-rate MBS, as we believe that homeowners with Hybrids and adjustable-rate mortgages exhibit more rapid housing turnover levels or refinancing activity compared to fixed-rate borrowers. In addition, we anticipate that prepayments on ARM-MBS accelerate significantly as the coupon reset date approaches. Over the last consecutive eight quarters, ending with December 31, 2008, the average quarterly CPR on our MBS portfolio ranged from a low of 8.5% to a high of 23.8%, with an average quarterly CPR of 14.9%. Our premium amortization, which reduces the yield earned on our MBS, is impacted by the amount of our purchase premiums relative to our MBS investments and is also affected by the speed

at which our MBS prepay. At December 31, 2008, we had net purchase premiums of \$125.0 million, or 1.3% of current par value, on our Agency MBS and net purchase discounts of \$11.7 million, or 3.4%, on non-Agency MBS.

CPR levels are impacted by conditions in the housing market, new regulations, government and private sector initiatives, interest rates, availability of credit to home borrowers and the economy in general. The following table presents the quarterly average CPR experienced on our MBS portfolio, on an annualized basis for the quarterly periods presented:

| Quarter Ended | CPR | |
|---------------|------|-------|
| | 2008 | 2007 |
| December 31 | 8.5% | 13.4% |
| September 30 | 10.3 | 18.1 |
| June 30 | 15.8 | 22.5 |
| March 31 | 14.3 | 23.8 |

Our CPR declined during the last two fiscal quarters of 2008. We believe that weakness in the housing market and the tightening of underwriting standards on mortgage loans contributed to a reduction in the speed at which our MBS prepaid. As of December 31, 2008, assuming a 15% CPR, which approximates the speed at which we estimate that our MBS generally prepay over time, approximately 23.0% of our MBS assets were expected to reset or prepay during the next 12 months and approximately 79.5% were expected to reset or prepay during the next 60 months, with an average time period until our assets prepay or reset of approximately 36 months. Our repurchase agreements, extended on average approximately 16 months, including the impact of Swaps, resulting in an asset/liability mismatch of approximately 20 months, assuming a 15% CPR, at December 31, 2008. (See following discussion on “Market Conditions.”)

At December 31, 2008, approximately \$9.356 billion, or 92.4%, of the Company’s MBS portfolio was in its contractual fixed-rate period and approximately \$765.6 million, or 7.6%, was in its contractual adjustable-rate period. Our MBS in their contractual adjustable-rate period include MBS collateralized by Hybrids for which the initial fixed-rate period has elapsed and the current interest rate on such MBS is generally adjusted on an annual basis.

The ARMs collateralizing our MBS are primarily comprised of Hybrids, which have interest rates that are typically fixed for three to ten years at origination and, thereafter, generally adjust annually to an increment over a specified interest rate index and, to a lesser extent, ARMs, which have interest rates that generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. At December 31, 2008, our ARM-MBS were indexed as follows: 76.4% to 12-month LIBOR; 6.4% to six-month LIBOR; 13.3% to the one-year CMT, 3.5% to the 12-month MTA and 0.4% to COFI. The amount by which our MBS can reset is limited by the interim and lifetime caps on the underlying mortgages. The following table presents information about the interim and lifetime caps on our ARM-MBS portfolio at December 31, 2008:

| Lifetime Caps on ARMs | | Interim Interest Rate Caps on ARMs | |
|------------------------|------------|------------------------------------|------------|
| Maximum | | Maximum | |
| Lifetime Interest Rate | % of Total | Interim Change in Rate | % of Total |
| 8.0% to 10.0% | 23.3% | 1.0% | 0.7% |
| >10.0% to 12.0% | 71.9 | 2.0% and 3.0% | 3.6 |
| >12.0% to 15.0% | 4.8 | 5.0% and 6.0% | 91.9 |
| | 100.0% | No interim caps | 3.8 |
| | | | 100.0% |

The following table presents certain benchmark interest rates at the dates indicated:

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| Year | Quarter Ended | 30-Day LIBOR | Six-Month LIBOR | 12-Month LIBOR | One-Year CMT | Two-Year Treasury | 10-Year Treasury | Target Federal Funds Rate/Range |
|------|---------------|-----------------|--------------------|-------------------|-----------------|----------------------|---------------------|---------------------------------------|
| 2008 | December 31 | 0.44% | 1.75% | 2.00% | 0.37% | 0.77% | 2.21% | 0.00 - 0.25% |
| | September 30 | 3.93 | 3.98 | 3.96 | 1.78 | 1.99 | 3.83 | 2.00 |
| | June 30 | 2.46 | 3.11 | 3.31 | 2.36 | 2.62 | 3.98 | 2.00 |
| | March 31 | 2.70 | 2.61 | 2.49 | 1.55 | 1.63 | 3.43 | 2.25 |
| 2007 | December 31 | 4.60% | 4.60% | 4.22% | 3.34% | 3.05% | 4.03% | 4.25% |
| | September 30 | 5.12 | 5.13 | 4.90 | 4.05 | 3.96 | 4.58 | 4.75 |
| | June 30 | 5.32 | 5.39 | 5.43 | 4.91 | 4.88 | 5.03 | 5.25 |
| | March 31 | 5.32 | 5.33 | 5.22 | 4.90 | 4.58 | 4.65 | 5.25 |

It is our business strategy to hold our MBS as long-term investments. On at least a quarterly basis, we assess our ability and intent to continue to hold each security and, as part of this process, we monitor our securities for other-than-temporary impairment. A change in our ability and/or intent to continue to hold any of our securities that are in an unrealized loss position, or deterioration in the underlying characteristics of these securities, could result in our recognizing future impairment charges or, a loss upon the sale of any such security. At December 31, 2008, we had net unrealized gains of \$55.9 million on our Agency MBS, comprised of gross unrealized gains of \$81.6 million and gross unrealized losses of \$25.7 million, and had net unrealized losses on our non-Agency MBS portfolio of \$128.9 million, comprised of gross losses of \$130.3 million and gross unrealized gains of \$1.4 million. At December 31, 2008, we expected to continue to hold each of our MBS that were in an unrealized loss position until recovery, which may be at their maturity. (See following discussion on "Market Conditions".)

During 2008, with respect to our hedging instruments: (i) we entered into 46 new Swaps with an aggregate notional amount of \$1.944 billion; (ii) we had Swaps with an aggregate notional amount of \$937.1 million amortize; and (iii) we terminated 48 Swaps with an aggregate notional amount of \$1.637 billion, in connection with the repayment of the repurchase agreements that such Swaps hedged, realizing net losses of \$91.5 million. We paid a weighted average fixed rate of 4.30% on our Swaps and received a variable rate of 3.05% for the year ended December 31, 2008. Our Swaps accounted for \$54.0 million, or 62 basis points, of our interest expense for the year ended December 31, 2008. At December 31, 2008, we had repurchase agreements of \$9.039 billion hedged with Swaps with an aggregate notional amount of \$3.970 billion. (See Note 5 to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

As market interest rates declined during 2008, the value of our Swaps decreased. At December 31, 2008, our Swaps were in an unrealized loss position of \$237.3 million. We expect the value of our Swaps will improve over the course of 2009, as they amortize and their remaining term shortens. During 2009, \$963.4 million, or 24.3% of our \$3.970 billion Swap notional amount is scheduled to amortize.

In response to market conditions during 2008, we postponed our planned initial public offering of MFResidential Investments, Inc., which was expected to invest primarily in residential MBS, non-Agency residential mortgage loans and other real estate-related financial assets. In November 2008, we formed MFR LLC as a wholly-owned subsidiary. We expect that MFR LLC will allow us to build a track record in the Senior MBS sector and help us to grow our future asset management business. Through December 31, 2008, we invested \$13.2 million in Senior MBS through MFR LLC. As a wholly-owned subsidiary, MFR LLC is consolidated with us.

We will continue to explore alternative business strategies, investments and financing sources and other strategic initiatives, including, but not limited to, the expansion of MFR LLC and our third-party advisory services, the creation of new investment vehicles to manage MBS and/or other real estate-related assets and the creation and/or acquisition of a third-party asset management business to complement our core business strategy of investing, on a leveraged basis, in high quality ARM-MBS. However, no assurance can be provided that any such strategic initiatives will or will not be implemented in the future or, if undertaken, that any such strategic initiatives will favorably impact us.

Market Conditions

The well publicized disruptions in the financial markets that began in 2007 escalated throughout 2008. In response, various initiatives by the U.S. Government have been implemented to address credit and liquidity issues. Among other things, in September 2008, Fannie Mae and Freddie Mac were placed under conservatorship by the FHFA and the U.S. Treasury announced it would purchase senior preferred stock in Fannie Mae or Freddie Mac, if needed, to a maximum of \$100 billion per company in order that each maintains positive net worth. In October 2008, the U.S. Treasury created the Capital Purchase Program, as part of the \$700 billion Troubled Asset Relief Program, allocating \$250 billion to invest in U.S. financial institutions to help stabilize and strengthen the U.S. financial system. In November 2008, the Federal Reserve announced that it would buy up to \$500 billion of Agency MBS. In January

2009, Federal Reserve began to purchase Agency MBS in accordance with this initiative. These actions and other coordinated global actions have partially restored the capital base and reduced funding risks for many of the world's largest financial institutions.

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We believe that the stronger backing for the guarantors of Agency MBS, resulting from the conservatorship of Fannie Mae and Freddie Mac and the U.S. Treasury's commitment to purchase senior preferred stock in these Agencies has, and are expected to continue to, positively impact the value of our Agency MBS. The Federal Reserve announcement on January 9, 2009, that it had begun to buy Agency MBS, resulted in an increase in the value of Agency MBS. At December 31, 2008, our assets remained concentrated in high-quality Agency MBS. As market prices of Agency MBS increased in January 2009, the spreads on Agency MBS narrowed relative to rates on U.S. Treasury bonds. Market yields on Senior MBS remained relatively high, providing a compelling investment opportunity for us. In December 2008, through a new wholly-owned subsidiary, MFR LLC, we invested \$13.2 million, on an unleveraged basis, in Senior MBS.

In December 2008, the Federal Reserve reduced the target Federal Funds rate to a range of 0.0% to 0.25%. As a result of various government initiatives, rates on conforming mortgages have declined, nearing historical lows. Hybrid and adjustable-rate mortgage originations have declined substantially, as rates on these types of mortgages are comparable with rates available on 30-year fixed-rate mortgages. While such significant decreases in mortgage rates would typically foster mortgage refinancing, such activity has not occurred. We believe that the decline in home values, increases in the jobless rate and the resulting deterioration in borrowers creditworthiness have limited refinance activity to date. There has been much discussion about potential legislation aimed to further assist homeowners in refinancing and to reduce potential foreclosures. While, based on current market interest rates, we expect that CPRs will trend upward during 2009, future CPRs will be affected by the timing and ultimate form of future legislation, if any, and the resulting impact on borrowers' ability to refinance, mortgage interest rates in the market and home values.

We continue to maintain leverage in accordance with our reduced leverage strategy adopted in March 2008. The following table presents our leverage multiples, as measured by debt-to-equity, at the dates presented:

| At the Period Ended | Leverage Multiple |
|---------------------|-------------------|
| December 31, 2008 | 7.2x |
| September 30, 2008 | 7.2 |
| June 30, 2008 | 6.7 |
| March 31, 2008 | 7.0 |
| December 31, 2007 | 8.1 |

RESULTS OF OPERATIONS

Year Ended December 31, 2008, Compared to Year Ended December 31, 2007

For 2008, we had net income available to our common stockholders of \$37.6 million, or \$0.21 per common share, compared to net income of \$22.1 million, or \$0.24 per common share, for 2007.

Interest income on our investment securities portfolio for 2008 increased by \$139.5 million, or 36.7%, to \$519.8 million compared to \$380.3 million for 2007. This increase reflects the growth in our MBS portfolio during the earlier part of 2008. Excluding changes in market values, our average investment in MBS increased by \$2.769 billion, or 40.2%, to \$9.656 billion for 2008 from \$6.887 billion for 2007. The net yield on our MBS portfolio decreased by 14 basis points, to 5.38% for 2008 compared to 5.52% for 2007. This decrease in the net yield on our MBS portfolio primarily reflects a 40 basis point decrease in the gross yield partially offset by a 21 basis point reduction in the cost of net premium amortization. The decrease in the gross yield on the MBS portfolio to 5.71% for 2008 from 6.11% for 2007 reflects the impact on our assets of the general decline in market interest rates. The decrease in the cost of our premium amortization to 20 basis points for 2008 from 41 basis points for 2007 reflects a decrease in the average CPR experienced on our portfolio as well as a decrease in the average premium on our MBS portfolio. Our average CPR

for 2008 was 12.0% compared to 19.1% for 2007, while the average purchase premium on our MBS portfolio was 1.3% for 2008 compared to 1.4% for 2007. At December 31, 2008, we had net purchase premiums of \$125.0 million, or 1.3% of current par value, on our Agency MBS and net purchase discounts of \$11.7 million, or 3.4%, on non-Agency MBS.

The following table presents the components of the net yield earned on our MBS portfolio for the quarterly periods presented:

| Year | Quarter Ended | Gross Yield/Stated Coupon | Net Premium Amortization | Other (1) | Net Yield |
|------|--------------------|---------------------------------|--------------------------------|-----------|-----------|
| 2008 | December 31, 2008 | 5.54% | (0.14)% | (0.11)% | 5.29% |
| | September 30, 2008 | 5.58 | (0.17) | (0.11) | 5.30 |
| | June 30, 2008 | 5.77 | (0.26) | (0.15) | 5.36 |
| | March 31, 2008 | 6.01 | (0.24) | (0.15) | 5.62 |
| 2007 | December 31, 2007 | 6.12% | (0.25)% | (0.14)% | 5.73% |
| | September 30, 2007 | 6.12 | (0.38) | (0.16) | 5.58 |
| | June 30, 2007 | 6.09 | (0.50) | (0.19) | 5.40 |
| | March 31, 2007 | 6.11 | (0.55) | (0.21) | 5.35 |

(1) Reflects the cost of delay and cost to carry purchase premiums.

Interest income from our cash investments increased to \$7.7 million for 2008 from \$4.5 million for 2007. This increase reflects the increase in our average cash investments to \$322.0 million for 2008 compared to \$93.4 million for 2007. Our cash investments, which are comprised of high quality money market investments, yielded 2.40% for 2008, compared to 4.81% for 2007, reflecting the decrease in market interest rates. In general, we manage our cash investments relative to our investing, financing and operating requirements, investment opportunities and current and anticipated market conditions. In response to tightening of market credit conditions in March 2008, we modified our leverage strategy, reducing our target debt-to-equity multiple from 8x to 9x to 7x to 9x. As a component of this strategy and to address increased volatility in the financial markets we increased our cash investments.

Our interest expense for 2008 increased to \$342.7 million from \$321.3 million for 2007, reflecting a significant increase in our borrowings, partially offset by a significant decrease in the interest rates we paid on such borrowings reflecting the decrease in market interest rates. The average amount outstanding under our repurchase agreements for 2008 increased by \$2.424 billion, or 38.9%, to \$8.653 billion from \$6.229 billion for 2007. The increase in our borrowing under repurchase agreements during 2008 primarily reflects our leveraging of multiple equity capital raises. We experienced a 120 basis point decrease in our effective cost of borrowings to 3.96% for 2008, from 5.16% for 2007. Payments made/received on our Swaps are a component of our borrowing costs. Our Swaps accounted for interest expense of \$54.0 million, or 62 basis points, for 2008 and decreased the cost of our borrowings by \$6.5 million, or ten basis points, for 2007. (See Notes 2(n) and 5 to the accompanying consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

Our funding costs increased slightly in January 2009, reflecting the impact of increased funding costs over the 2008 year-end. However, based on current LIBOR and market rates available on repurchase agreements, we expect that our overall funding costs will begin to trend downward starting in February 2009.

For 2008, our net interest income increased to \$184.8 million from \$63.5 million for 2007. This increase reflects the growth in our interest-earning assets and an improvement in our net interest spread, as MBS yields relative to our cost of funding widened. Our net interest spread and margin were 1.32% and 1.85%, respectively, for 2008, compared to 0.35% and 0.91%, respectively, for 2007.

The following table presents certain quarterly information regarding our net interest spreads and net interest margin for the quarterly periods presented:

| Quarter Ended | Total Interest-Earning Assets and Interest-Bearing Liabilities | | | MBS Only | |
|--------------------|--|----------------------------|---------------------|---------------------------|-------------------|
| | Net Interest Spread | Net Interest Margin (1) | Net Yield on MBS | Cost of Funding MBS | Net MBS Spread |
| December 31, 2008 | 1.37% | 1.91% | 5.29% | 3.82% | 1.47% |
| September 30, 2008 | 1.61 | 2.09 | 5.30 | 3.60 | 1.70 |
| June 30, 2008 | 1.38 | 1.89 | 5.36 | 3.85 | 1.51 |
| March 31, 2008 | 0.90 | 1.47 | 5.62 | 4.64 | 0.98 |
| December 31, 2007 | 0.65 | 1.22 | 5.73 | 5.05 | 0.68 |

(1) Net interest income divided by average interest-earning assets.

The following table presents information regarding our average balances, interest income and expense, yield on average interest-earning assets, average cost of funds and net interest income for the quarters presented:

| Quarter Ended | Average Amortized Cost of MBS (1) | Interest Income on Investment Securities | Average Interest- Earning Cash, Cash Equivalents and Restricted Cash | Total Interest Income | Yield on Average Interest-Earning Assets | Average Balance of Repurchase Agreements | Interest Expense | Average Cost of Funds | Net Interest Income |
|--------------------|--|---|--|-----------------------------|--|---|---------------------|-----------------------------|---------------------------|
| | | | | | | | | | |
| December 31, 2008 | \$ 10,337,787 | \$ 136,762 | \$ 284,178 | \$ 137,780 | 5.19% | \$ 9,120,214 | \$ 87,522 | 3.82% | \$ 50,258 |
| September 30, 2008 | 10,530,924 | 139,419 | 281,376 | 140,948 | 5.21 | 9,373,968 | 85,033 | 3.60 | 55,915 |
| June 30, 2008 | 8,844,406 | 118,542 | 375,326 | 120,693 | 5.23 | 8,001,835 | 76,661 | 3.85 | 44,032 |
| March 31, 2008 | 8,902,340 | 125,065 | 347,970 | 128,096 | 5.54 | 8,100,961 | 93,472 | 4.64 | 34,624 |
| December 31, 2007 | 7,681,065 | 109,999 | 196,344 | 112,284 | 5.70 | 6,975,521 | 88,881 | 5.05 | 23,403 |

(1) Unrealized gains and losses are not reflected in the average amortized cost of MBS.

For 2008, we had net other operating losses of \$120.1 million compared to net other operating losses of \$20.1 million for 2007. We modified our leverage strategy in March 2008, to reduce risk in light of the significant disruptions in the credit markets, by decreasing our target debt-to-equity multiple range from 8x to 9x to 7x to 9x. To effect this change, during the first quarter of 2008, we sold 84 MBS for \$1.851 billion, resulting in net losses of \$24.5 million, and terminated 48 Swaps with an aggregate notional amount of \$1.637 billion, realizing losses of \$91.5 million. In addition, during 2008, we recognized losses of \$986,000 in connection with two Swaps terminated in response to the Lehman bankruptcy in September 2008. Lastly, we recognized other-than-temporary impairment charges of \$5.1 million, of which \$4.9 million reflected a full write-off against two unrated investment securities and \$183,000 was an impairment charge against one non-Agency MBS that was rated BB. In the aggregate, these transactions resulted in net losses of \$122.0 million for 2008. During 2007, we realized losses of \$21.8 million on the sale of Agency and AAA rated MBS, of which \$22.0 million were incurred during the third quarter of 2007. Also included in our other

loss, net is revenue from our one real estate investment, which remained relatively flat at approximately \$1.6 million. We do not expect that the results from our real estate investment net of the related operating expenses and mortgage interest (which are included in our operating and other expense) will be significant to our future results of operations. We earned \$303,000 and \$424,000 in advisory fees during 2008 and 2007, respectively, which are included in miscellaneous other income, net.

For 2008, we had operating and other expenses of \$18.9 million, including real estate operating expenses and mortgage interest totaling \$1.8 million attributable to our investment in one multi-family rental property. In May 2008, in response to equity market conditions, we postponed the initial public offering of MFResidential Investments, Inc. and, as a result, incurred total expenses of \$1.2 million through December 31, 2008; in connection with this business initiative. For 2008, our compensation and benefits and other general and administrative expense were \$15.9 million, or 0.16% of average assets, compared to \$11.7 million, or 0.17% of average assets, for 2007. The \$3.9 million increase in our employee compensation and benefits expense for 2008 compared to 2007 primarily reflects an increase of \$2.1 million for bonuses, an \$821,000 increase in salary expense associated with additional hires and salary increases and a \$923,000 increase for equity based compensation for employees. Other general and administrative expenses, which were \$5.5 million for 2008 compared to \$5.1 million for 2007, were comprised primarily of the cost of professional services, including auditing and legal fees, costs of complying with the provisions of the SOX Act, office rent, corporate insurance, Board fees and miscellaneous other operating costs.

Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

For 2007, we had net income available to our common stockholders of \$22.1 million, or \$0.24 per common share, compared to net income of \$598,000, or \$0.01 per share, for 2006. During 2007 and 2006, we repositioned our MBS portfolio, realizing net losses on the sale of MBS of \$21.8 million and \$23.1 million, respectively. In addition, our 2006 net income was positively impacted by the net results of our discontinued operations, which was comprised of a net gain realized on the sale of two multi-family apartment properties net of such properties' operating losses.

Interest income on our investment securities portfolio for 2007 increased by \$163.4 million, or 75.4%, to \$380.3 million compared to \$216.9 million for 2006. This increase in interest income reflects the growth in, and an increase in the yield earned on, our MBS portfolio. Our MBS yield was positively impacted by purchases of higher yielding 7/1 and 10/1 MBS and the repositioning of our portfolio in response to market conditions, whereby, in addition to reducing our non-Agency MBS concentration, we sold lower yielding, longer duration Agency MBS. Excluding changes in market values, our average investment in MBS increased by \$2.142 billion, or 45.2%, to \$6.887 billion for 2007 from \$4.744 billion for 2006. The net yield on our MBS portfolio increased to 5.52% for 2007 from 4.57% for 2006. This increase primarily reflects a 66 basis point increase in the gross yield on the MBS portfolio to 6.11% for 2007 from 5.45% for 2006 and a 27 basis point reduction in the cost of net premium amortization. The cost of our premium amortization decreased to 41 basis points for 2007 from 68 basis points for 2006. This decrease in the cost of our premium amortization during 2007 reflects a decrease in the average CPR experienced on our portfolio to 19.1% for 2007 from 25.7% for 2006 as well as a decrease in the average purchase premium on our MBS portfolio to 1.4% for 2007 from 1.8 % for 2006.

The following table presents the components of the net yield earned on our MBS portfolio for the quarterly periods presented:

| Year | Quarter Ended | Gross Yield/Net Premium | | | Net Yield |
|------|---------------|-------------------------|--------------|-----------|-----------|
| | | Coupon | Amortization | Other (1) | |
| 2007 | December 31 | 6.12% | (0.25)% | (0.14)% | 5.73% |
| | September 30 | 6.12 | (0.38) | (0.16) | 5.58 |
| | June 30 | 6.09 | (0.50) | (0.19) | 5.40 |
| | March 31 | 6.11 | (0.55) | (0.21) | 5.35 |
| 2006 | December 31 | 6.04% | (0.64)% | (0.22)% | 5.18% |
| | September 30 | 5.74 | (0.70) | (0.21) | 4.83 |
| | June 30 | 5.16 | (0.76) | (0.19) | 4.21 |
| | March 31 | 4.86 | (0.64) (2) | (0.18) | 4.04 |

(1) Reflects the cost of delay and cost to carry purchase premiums.

(2) The cost of net premium amortization for the quarter ended March 31, 2006 was lower as a result of a \$20.7 million impairment charge taken against certain MBS at December 31, 2005. This impairment charge resulted in a new cost basis for the MBS that were identified as impaired which reduced our purchase premiums on these assets, which in turn reduced our purchase premium amortization as they were sold or prepaid. During the quarter ended March 31, 2006, we sold all of the MBS that were identified as impaired.

Interest income from our cash investments increased by \$2.2 million to \$4.5 million for 2007 from \$2.3 million for 2006. Our average cash investments increased by \$43.4 million to \$93.4 million for 2007 compared to \$50.0 million for 2006 and yielded 4.81% for 2007 compared to 4.65% for 2006. In general, we manage our cash investments relative to our investing, financing, operating requirements, investment opportunities and current and anticipated

market conditions. During the third quarter ended September 30, 2007, our yield on cash investments began to decline, in line with declining market interest rates.

Our borrowings under repurchase agreements increased as we leveraged equity capital raised during 2007 to grow our MBS portfolio. Our average repurchase agreements for 2007 increased by \$2.141 billion, or 52.4%, to \$6.229 billion from \$4.088 billion for 2006. We experienced a 71 basis point increase in our effective cost of borrowing to 5.16% for 2007 from 4.45% for 2006. This increase in rate paid on our borrowings reflects the higher market rates paid on incremental borrowings and repurchase agreements that matured during 2007. Our Hedging Instruments reduced the cost of our borrowings by \$6.6 million, or ten basis points, for 2007 and \$5.2 million, or 13 basis points, for 2006. Our interest expense for 2007 increased by 76.6% to \$321.3 million, from \$181.9 million for 2006, reflecting an increase in the amount of, and interest rate paid on, our borrowings.

Our cost of funding on the hedged portion of our repurchase agreements is in effect fixed, over the term of the related Swap, such that the interest rate on our hedged repurchase agreements will not decrease in connection with the recent decline in market interest rates, but rather will remain at the fixed Swap rate over the term of the Swap. At December 31, 2007, we had repurchase agreements of \$7.526 billion and Swaps with an aggregate notional amount of \$4.628 billion which had a weighted average fixed pay rate of 4.83% and a weighted average remaining term of 30 months. The remainder of our repurchase agreements, which are not hedged, had a weighted average term of 15 months at December 31, 2007. (See Notes 2(n) and 5 to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

For 2007, our net interest income increased by \$26.2 million, or 70.4%, to \$63.5 million, from \$37.3 million for 2006. This increase reflects the growth in our interest-earning assets, an increase in the yield on our MBS and an improvement in our net interest spread as MBS yields relative to our cost of funding widened. For 2007, our net interest spread and margin increased to 0.35% and 0.91%, respectively, from 0.12% and 0.78%, respectively, for 2006. The following table presents quarterly information regarding our net interest spread and net interest margin for the quarters presented:

| For the Quarter Ended | Net Interest Spread | Net Interest Margin |
|--------------------------|---------------------|---------------------|
| December 31, 2007 | 0.65% | 1.22% |
| September 30, 2007 | 0.36 | 0.90 |
| June 30, 2007 | 0.20 | 0.74 |
| March 31, 2007 | 0.16 | 0.73 |
| December 31, 2006 | 0.08 | 0.72 |

The following table presents information regarding our average balances, interest income and expense, yields on average interest-earning assets, average cost of funds and net interest income for the quarterly periods presented:

| For the Quarter Ended (Dollars in Thousands) | Average Amortized Cost of MBS (1) | Interest Income on Investment Securities | Average Interest-Earning Cash, Cash Equivalents and Restricted Cash | | Yield on Average Balance of Repurchase Agreements | | Interest Expense | Average Cost of Funds | Net Interest Income |
|--|--|---|--|--------------------------------|--|---|---------------------|-----------------------------|---------------------------|
| | | | Total Interest Income | Interest- Earning Assets | Average Interest- Earning Assets | Average Balance of Repurchase Agreements | | | |
| December 31, 2007 | \$ 7,681,065 | \$ 109,999 | \$ 196,344 | \$ 112,284 | 5.70% | \$ 6,975,521 | \$ 88,881 | 5.05% | \$ 23,403 |
| September 30, 2007 | 6,852,994 | 95,590 | 90,006 | 96,716 | 5.57 | 6,225,695 | 81,816 | 5.21 | 14,900 |
| June 30, 2007 | 6,696,979 | 90,392 | 51,160 | 91,026 | 5.39 | 6,051,209 | 78,348 | 5.19 | 12,678 |
| March 31, 2007 | 6,300,491 | 84,347 | 34,443 | 84,795 | 5.35 | 5,647,700 | 72,260 | 5.19 | 12,535 |
| December 31, 2006 | 5,469,461 | 70,836 | 52,412 | 71,480 | 5.18 | 4,833,897 | 62,114 | 5.10 | 9,366 |

(1) Unrealized gains and losses are not reflected in the average amortized cost of MBS.

For 2007, we had a net other loss of \$20.1 million compared to a net other loss of \$20.8 million for 2006. Our net other losses for both periods were primarily comprised of losses realized on sales of our MBS. During 2007, we realized losses of \$21.8 million on sales of Agency and AAA rated, which primarily occurred during the third quarter of 2007. As a result of these sales, we decreased the size of our non-Agency portfolio and positively impacted the spreads earned on our MBS portfolio by disposing of lower-yielding Agency MBS acquired prior to 2006. During

2006, we realized a net loss of \$23.1 million on sales of MBS, as a result of the repositioning of our MBS portfolio.

During 2007, we realized a net loss of \$384,000 on the early termination of six Swaps, which had an aggregate notional amount of \$305.2 million, upon the satisfaction of the repurchase agreements that such Swaps hedged. We earned \$424,000 and \$724,000 in advisory fees during 2007 and 2006, respectively, which are included in miscellaneous other income, net. Revenue from our real estate investment remained relatively flat at approximately \$1.6 million. (See Note 6(a) to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

For 2007, we had operating and other expenses of \$13.4 million, including real estate operating expenses and mortgage interest totaling \$1.8 million attributable to our one remaining real estate investment. For 2007, our non-real estate related overhead, comprised of compensation and benefits and other general and administrative expense, was \$11.7 million, or 0.17% of average assets, compared to \$9.6 million, or 0.20% of average assets, for 2006. Our expenses as a percentage of our average assets decreased, as we grew our average assets by leveraging our existing and new equity capital during 2007. The cost of our compensation and benefits increased by \$890,000 for 2007 compared to the 2006, reflecting an increase in compensation to existing employees and our additional hires. Our compensation expense of \$6.6 million for 2007 included aggregate non-cash share-based expenses of \$512,000, compared to \$539,000 for 2006. (See Note 13 to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.) Our other general and administrative expenses for 2007 were comprised primarily of the cost of professional services, including auditing and legal fees, costs of complying with the provisions of the SOX Act, office rent, corporate insurance, Board fees and miscellaneous other operating costs. The increase in our other general and administrative expense for 2007 to \$5.1 million from \$3.8 million for 2006, primarily reflects the cost of our additional office space as we grew and the renewal of our existing lease at our headquarters at current market rates commencing with the second quarter of 2007.

For 2007, we recognized \$257,000 of income from discontinued operations related to a reduction of the \$1.8 million built-in-gains tax of recognized on the sale of the Greenhouse, a 128-unit multi-family apartment building in Omaha, Nebraska, during 2006. During 2006, we reported income of \$3.5 million from discontinued operations, or \$0.04 per common share, which primarily reflected a net gain of \$4.4 million realized on sales of two real estate properties and related prepayment penalties of \$712,000 incurred on the satisfaction of the mortgages secured by those properties. The loss of \$198,000 from discontinued operations for 2006 reflected the reclassified net results of operations for the two properties sold during such year. (See Notes 2(h) and 6(b) to the consolidated financial statements, included under Item 8 of this annual report on Form 10-K.)

CRITICAL ACCOUNTING POLICIES