DYNEX CAPITAL INC
Form 10-Q
November 09, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

R Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2011
or
£ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 1-9819

DYNEX CAPITAL, INC.
(Exact name of registrant as specified in its charter)

Virginia	52-1549373
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia	23060-9245
(Address of principal executive offices)	(Zip Code)

(804) 217-5800
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes R No £

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

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

Large accelerated filer	£	Accelerated filer	R
Non-accelerated filer	£ (Do not check if a smaller reporting company)	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 R

On November 3, 2011, the registrant had 40,380,797 shares outstanding of common stock, $0.01 par value, which is the registrant's only class of common stock.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DYNEX CAPITAL, INC.
CONSOLIDATED BALANCE SHEETS
(amounts in thousands except share data)

	September 30, 2011 (unaudited)	December 31, 2010
ASSETS		
Agency MBS (including pledged of $1,893,209 and $1,090,174, respectively)	$2,072,110	$1,192,579
Non-Agency MBS (including pledged of $367,642 and $259,350, respectively)	403,705	267,356
Securitized mortgage loans, net	118,700	152,962
Other investments, net	1,059	1,229
	2,595,574	1,614,126
Cash and cash equivalents	10,156	18,836
Derivative assets	—	692
Principal receivable on investments	10,305	3,739
Accrued interest receivable	12,353	6,105
Other assets, net	5,298	6,086
Total assets	$2,633,686	$1,649,584
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	$2,053,686	$1,234,183
Payable for securities pending settlement	74,098	—
Non-recourse collateralized financing	84,013	107,105
Derivative liabilities	28,838	3,532
Accrued interest payable	1,240	1,079
Accrued dividends payable	10,903	8,192
Other liabilities	11,374	3,136
Total liabilities	2,264,152	1,357,227
Commitments and Contingencies (Note 12)		
Shareholders' equity:		
Common stock, par value $.01 per share, 100,000,000 shares authorized; 40,380,276 and 30,342,897 shares issued and outstanding, respectively	404	303
Additional paid-in capital	634,317	538,304
Accumulated other comprehensive (loss) income	(1,605)	10,057
Accumulated deficit	(263,582)	(256,307)
Total shareholders' equity	369,534	292,357
Total liabilities and shareholders' equity	$2,633,686	$1,649,584

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(amounts in thousands except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest income:				
Agency MBS	$14,898	$5,607	$41,660	$15,085
Non-Agency MBS	4,442	3,345	11,963	9,586
Securitized mortgage loans	1,773	2,748	5,953	9,726
Other investments	29	30	91	94
Cash and cash equivalents	1	4	6	9
	21,143	11,734	59,673	34,500
Interest expense:				
Repurchase agreements	5,305	1,672	13,493	4,297
Non-recourse collateralized financing	1,278	1,661	3,856	6,674
	6,583	3,333	17,349	10,971
Net interest income	14,560	8,401	42,324	23,529
Provision for loan losses	(300)	(211)	(750)	(770)
Net interest income after provision for loan losses	14,260	8,190	41,574	22,759
Litigation settlement and related costs	(8,240)	—	(8,240)	—
(Loss) gain on non-recourse collateralized financing	(1,970)	561	(1,970)	561
Gain on sale of investments, net	581	—	1,323	794
Fair value adjustments, net	(662)	77	(657)	230
Other (loss) income, net	(102)	165	84	1,389
General and administrative expenses:				
Compensation and benefits	(1,106)	(1,191)	(3,447)	(3,033)
Other general and administrative	(1,229)	(780)	(3,261)	(2,874)
Net income	1,532	7,022	25,406	19,826
Preferred stock dividends	—	(1,056)	—	(3,061)
Net income to common shareholders	$1,532	$5,966	$25,406	$16,765
Weighted average common shares:				
Basic	40,353	17,230	37,973	15,532
Diluted	40,353	21,457	37,974	19,757
Net income per common share:				
Basic	$0.04	$0.35	$0.67	$1.08
Diluted	$0.04	$0.33	$0.67	$1.00
Dividends declared per common share	$0.27	$0.25	$0.81	$0.94

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(amounts in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income	$1,532	$7,022	$25,406	$19,826
Other comprehensive income:				
Change in market value of available-for-sale securities	7,145	2,212	13,310	14,199
Reclassification adjustment for net gain on sale of investments, net	(581)	—	(1,323)	(779)
Net unrealized loss on cash flow hedging instruments	(14,868)	(2,048)	(23,649)	(5,881)
Other comprehensive (loss) income	(8,304)	164	(11,662)	7,539
Comprehensive (loss) income	(6,772)	7,186	13,744	27,365
Dividends declared on preferred stock	—	(1,056)	—	(3,061)
Comprehensive (loss) income to common shareholders	$(6,772)	$6,130	$13,744	$24,304

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(amounts in thousands)

	Nine Months Ended September 30,	
	2011	2010
Operating activities:		
Net income	$25,406	$19,826
Adjustments to reconcile net income to cash provided by operating activities:		
(Increase) decrease in accrued interest receivable	(6,248)	451
Increase (decrease) in accrued interest payable	161	(418)
Provision for loan losses	750	770
Gain on sale of investments, net	(1,323)	(794)
Loss (gain) on non-recourse collateralized financing	1,970	(561)
Fair value adjustments, net	657	(230)
Increase in litigation settlement and related costs reserve	7,861	—
Amortization and depreciation	22,312	4,266
Stock-based compensation expense	492	558
Net change in other assets and other liabilities	1,564	(3,302)
Net cash and cash equivalents provided by operating activities	53,602	20,566
Investing activities:		
Purchase of investments	(1,440,594)	(432,182)
Principal payments received on investments	344,649	207,485
(Increase) decrease in principal receivable on investments	(6,566)	168
Proceeds from sales of investments	124,797	50,882
Principal payments received on securitized mortgage loans	32,655	51,109
Other investing activities	77	(295)
Net cash and cash equivalents used in investing activities	(944,982)	(122,833)
Financing activities:		
Borrowings under repurchase agreements, net	819,503	106,818
Borrowings under non-recourse collateralized financing	—	50,678
Principal payments on non-recourse collateralized financing	(2,094)	(42,652)
Cash paid to redeem non-recourse collateralized financing	—	(56,406)
Proceeds from issuance of common stock	95,261	44,010
Dividends paid	(29,970)	(13,160)
Net cash and cash equivalents provided by financing activities	882,700	89,288
Net decrease in cash and cash equivalents	(8,680)	(12,979)
Cash and cash equivalents at beginning of period	18,836	30,173
Cash and cash equivalents at end of period	$10,156	$17,194
Supplemental Disclosure of Cash Activity:		
Cash paid for interest	$16,411	$11,751

See notes to unaudited consolidated financial statements.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements of Dynex Capital, Inc. and its qualified real estate investment trust (“REIT”) subsidiaries and its taxable REIT subsidiary (together, “Dynex” or the “Company”) have been prepared in accordance with the instructions to the Quarterly Report on Form 10-Q and Article 10, Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America (“GAAP”) for complete financial statements. In the opinion of management, all significant adjustments, consisting of normal recurring accruals considered necessary for a fair presentation of the consolidated financial statements, have been included. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2011. The unaudited consolidated financial statements included herein should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC.

Certain items in the prior year’s consolidated financial statements have been reclassified to conform to the current year’s presentation. The Company’s consolidated balance sheet for December 31, 2010 now presents separately its "principal receivable on investments", which was previously included within the fair value amounts shown for Agency and non-Agency mortgage-backed securities ("MBS"). The Company's consolidated statement of income for the three and nine months ended September 30, 2010 now present separately "(loss) gain on non-recourse collateralized financing", which was previously included within "other (loss) income, net" for those periods. The Company’s consolidated statement of cash flows for the nine months ended September 30, 2010 now presents separately “(increase) decrease in principal receivable on investments”, which was previously included within “other investing activities” for that period. In addition, the line item "gain on redemption of securitization financing bonds" on the statement of cash flows for the nine months ended September 30, 2010 has been renamed "(loss) gain on non-recourse collateralized financing". These presentation changes have no effect on reported total assets, total liabilities, results of operations, or cash flow activities.

Consolidation of Subsidiaries

The consolidated financial statements include the accounts of the Company, its qualified REIT subsidiaries and its taxable REIT subsidiary. The consolidated financial statements represent the Company’s accounts after the elimination of intercompany balances and transactions. The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others and variable interest entities in which it is determined to be the primary beneficiary in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 810. The Company follows the equity method of accounting for investments with greater than a 20% and less than 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 50% of the voting equity.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and

liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management include but are not limited to fair value measurements of its investments, allowance for loan losses, other-than-temporary impairments, commitments and contingencies, and amortization of premiums and discounts. These items are discussed further below within this note to the consolidated financial statements.

Federal Income Taxes

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the “Code”). As such, the Company believes that it qualifies as a REIT for federal income tax purposes, and it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders. The Company uses the calendar year for both tax and financial reporting purposes. There may be differences

between taxable income and income computed in accordance with GAAP.

Investments

The Company’s investments include Agency MBS, non-Agency MBS, securitized mortgage loans, and other investments.

Agency MBS. Agency MBS are comprised of residential mortgage-backed securities (“RMBS”) and commercial mortgage-backed securities (“CMBS”) issued or guaranteed by a federally chartered corporation, such as Federal National Mortgage Corporation, or Fannie Mae, or Federal Home Loan Mortgage Corporation, or Freddie Mac, or an agency of the U.S. government, such as Government National Mortgage Association, or Ginnie Mae. The Company’s Agency RMBS are comprised primarily of hybrid Agency adjustable-rate mortgage loans ("ARMs") and Agency ARMs. Hybrid Agency ARMs are MBS collateralized by hybrid adjustable-rate mortgage loans which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and which then adjust their interest rate at least annually to an increment over a specified interest rate index as further discussed below. Agency ARMs are MBS collateralized by adjustable-rate mortgage loans which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index. Agency ARMs also include hybrid Agency ARMs that are past their fixed-rate periods or within twelve months of their initial reset period.

Interest rates on the adjustable-rate mortgage loans collateralizing hybrid Agency ARMs or Agency ARMs are based on specific index rates, such as the one-year constant maturity treasury rate, or CMT, the London Interbank Offered Rate, or LIBOR, the Federal Reserve U.S. 12-month cumulative average one-year CMT, or MTA, or the 11th District Cost of Funds Index, or COFI. These loans will typically have interim and lifetime caps on interest rate adjustments, or interest rate caps, limiting the amount that the rates on these loans may reset in any given period.

The Company’s Agency CMBS are typically comprised of fixed-rate securities issued by Fannie Mae or Freddie Mac. Securities of both of these issuers are collateralized by first mortgage loans on multifamily properties that are usually either locked out of prepayment options or have yield maintenance provisions which provide the Company protection against prepayment of the investment.

A portion of the Company's Agency CMBS also include interest only securities ("IOs") which represent the right to receive contractual interest flows (but not principal cash flows) from the underlying unamortized principal balance of specific Agency CMBS.

The Company accounts for its Agency MBS in accordance with ASC Topic 320, which requires that investments in debt and equity securities be designated as either “held-to-maturity,” “available-for-sale” or “trading” at the time of acquisition. As of September 30, 2011, the Company has Agency MBS that are designated as either available-for-sale or trading. Although the Company generally intends to hold its available-for-sale securities until maturity, it may, from time to time, sell any of these securities as part of the overall management of its business. The available-for-sale designation provides the Company with this flexibility.

All of the Company’s Agency MBS are recorded at their fair value on the consolidated balance sheet. The Company determines the fair value of its Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. Changes in the fair value of Agency MBS designated as trading are recognized in net income within “fair value adjustments, net”. Gains (losses) realized upon the sale, impairment, or other disposal of a trading security are also recognized within “fair value adjustments, net”. Alternatively, changes in the fair value of Agency MBS designated as available-for-sale are reported in other comprehensive income as unrealized gains (losses) until the security is collected, disposed of, or determined to be other than temporarily impaired. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income (“AOCI”) into net

income as a realized “gain (loss) on sale of investments, net” using the specific identification method.

Non-Agency MBS. The Company’s non-Agency MBS are comprised of RMBS and CMBS, the majority of which are rated as investment grade. Interest rates for non-Agency MBS collateralized with ARMs are based on indices similar to those of Agency MBS. A portion of the Company's non-Agency CMBS also includes non-Agency interest-only securities (IOs) that, as with Agency IOs, represent the right to receive contractual interest flows (but not principal cash flows) from the underlying unamortized principal balance of specific non-Agency CMBS.

Like Agency MBS, the Company accounts for its non-Agency MBS in accordance with ASC Topic 320. As of September 30, 2011, all of the Company’s non-Agency MBS are designated as available-for-sale and are recorded at their fair value on the consolidated balance sheet. Changes in fair value are reported in other comprehensive income until the security is collected, disposed of, or determined to be other than temporarily impaired. Upon the sale of an available-for-sale security, any

unrealized gain or loss is reclassified out of AOCI into net income as a realized “gain (loss) on sale of investments, net” using the specific identification method.

The Company determines the fair value for certain of its non-Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The remainder of the non-Agency MBS are valued by discounting the estimated future cash flows derived from pricing models that utilize information such as the security’s coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected losses, credit enhancement, as well as certain other relevant information.

Securitized Mortgage Loans. Securitized mortgage loans consist of loans pledged to support the repayment of securitization financing bonds issued by the Company. Securitized mortgage loans are reported at amortized cost. An allowance has been established for currently existing estimated losses on such loans. Securitized mortgage loans can only be sold subject to the lien of the respective securitization financing indenture.

Other Investments. Other investments include unsecuritized single-family and commercial mortgage loans which are carried at amortized cost.

Allowance for Loan Losses

An allowance for loan losses has been estimated and established for currently existing and probable losses for mortgage loans that are considered impaired. Provisions made to increase the allowance are charged as a current period expense. Commercial mortgage loans are secured by income-producing real estate and are evaluated individually for impairment when the debt service coverage ratio on the mortgage loan is less than 1:1 or when the mortgage loan is delinquent. An allowance may be established for a particular impaired commercial mortgage loan. Commercial mortgage loans not evaluated for individual impairment are evaluated for a general allowance. Certain of the commercial mortgage loans are covered by mortgage loan guarantees that limit the Company’s exposure on these mortgage loans. Single-family mortgage loans are considered homogeneous and are evaluated on a pool basis for a general allowance.

The Company considers various factors in determining its specific and general allowance requirements, including whether a loan is delinquent, the Company’s historical experience with similar types of loans, historical cure rates of delinquent loans, and historical and anticipated loss severity of the mortgage loans as they are liquidated. The factors may differ by mortgage loan type (e.g., single-family versus commercial) and collateral type (e.g., multifamily versus office property). The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience.

Repurchase Agreements

Repurchase agreements are treated as financings in accordance with the provision of ASC Topic 860 under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. The Company’s repurchase agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by

both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

Securitization Transactions

The Company has securitized mortgage loans and non-Agency CMBS through securitization transactions by transferring financial assets to a wholly owned trust, where the trust issues non-recourse securitization financing bonds pursuant to an indenture. The Company retains some form of control over the transferred assets, and therefore the trust is included in the consolidated financial statements of the Company. For accounting and tax purposes, the loans and securities financed through the issuance of bonds in a securitization financing transaction are treated as assets of the Company (presented as securitized mortgage loans on the consolidated balance sheet), and the associated bonds issued are treated as debt of the Company (presented as a portion of non-recourse collateralized financing on the consolidated balance sheet). The Company has retained certain of the bonds issued by the trust and has transferred collateral in excess of the bonds issued. This excess is typically referred to as over-

collateralization. Each securitization trust generally provides the Company the right to redeem, at its option, the remaining outstanding bonds prior to their maturity date.

Derivative Instruments

The Company may enter into interest rate swap agreements, interest rate cap agreements, interest rate floor agreements, financial forwards, financial futures and options on financial futures ("interest rate agreements") to manage its sensitivity to changes in interest rates. The Company accounts for its interest rate agreements under ASC Topic 815, designating each as either a cash flow hedging position or a trading position using criteria established therein. In order to qualify as a cash flow hedge, ASC Topic 815 requires formal documentation to be prepared at the inception of the interest rate agreement that meets certain conditions. If these conditions are not met, an interest rate agreement will be classified as a trading position.

For interest rate agreements designated as trading positions, the Company records these instruments at fair value on the Company's balance sheet in accordance with ASC Topic 815. Changes in their market value are measured at each reporting date and recognized in the current period's statement of income.

For interest rate agreements designated as cash flow hedges, the Company evaluates the effectiveness of these hedges against the financial instrument being hedged. The effective portion of the hedge relationship on an interest rate agreement designated as a cash flow hedge is reported in AOCI and is later reclassified into the consolidated statement of income in the same period during which the hedged transaction affects earnings. The ineffective portion of such hedge is immediately reported in the current period's consolidated statement of income. These derivative instruments are carried at fair value on the Company's consolidated balance sheets in accordance with ASC Topic 815. Cash posted to meet margin calls, if any, is included on the consolidated balance sheets in other assets.

The Company may be required periodically to terminate hedging instruments. Any basis adjustments or changes in the fair value of hedges recorded in AOCI are recognized into income or expense in conjunction with the original hedge or hedged exposure.

If the underlying asset, liability or commitment is sold or matures, the hedge is deemed partially or wholly ineffective, or if the criterion that was established at the time the hedging instrument was entered into no longer exists, the interest rate agreement no longer qualifies as a designated hedge. Under these circumstances, such changes in the market value of the interest rate agreement are recognized in the current period's statement of income.

Interest Income

Interest income on Agency and non-Agency MBS that are rated "AAA" and loans is recognized over the expected life of the investment using the effective interest method. Interest income on non-Agency MBS that are rated "AA" or lower is recognized over the expected life as adjusted for estimated prepayments and credit losses of the securities in accordance with ASC Topic 325. For loans, the accrual of interest is discontinued when, in the opinion of management, the interest is not collectible in the normal course of business, when the loan is significantly past due or when the primary servicer of the loan fails to advance the interest and/or principal due on the loan. Loans are considered past due when the borrower fails to make a timely payment in accordance with the underlying loan agreement. For securities and other investments, the accrual of interest is discontinued when, in the opinion of management, it is probable that all amounts contractually due will not be collected. All interest accrued but not collected for investments that are placed on a non-accrual status or are charged-off is reversed against interest income. Interest on these investments is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Investments are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Amortization of Premiums, Discounts, and Deferred Issuance Costs

Premiums and discounts on investments and obligations, as well as debt issuance costs and hedging basis adjustments, are amortized into interest income or expense, respectively, over the contractual life of the related investment or obligation using the effective interest method in accordance with ASC Topic 310 and ASC Topic 470. For securities representing beneficial interests in securitizations that are not highly rated, unamortized premiums and discounts are recognized over the expected life, as adjusted for estimated prepayments and credit losses of the securities, in accordance with ASC Topic 325. Actual prepayment and credit loss experience are reviewed, and effective yields are recalculated, when originally anticipated prepayments and credit losses differ from amounts actually received plus anticipated future prepayments.

Other-than-Temporary Impairments

The Company evaluates all debt securities in its investment portfolio for other-than-temporary impairments by applying the guidance prescribed in ASC Topic 320, which states that a debt security is considered to be other-than-temporarily impaired if the present value of cash flows expected to be collected is less than the security's amortized cost basis (the difference being defined as the credit loss) or if the fair value of the security is less than the security's amortized cost basis and the Company intends, or is required, to sell the security before recovery of the security's amortized cost basis. Although the principal and interest related to Agency MBS are guaranteed by the issuers, who have the implicit guarantee of the U.S. government, the Company assesses its ability to hold an Agency MBS with an unrealized loss until the recovery in its value.

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. Any remaining difference between fair value and amortized cost is recognized in other comprehensive income.

In certain instances, as a result of the other-than-temporary impairment analysis, the recognition or accrual of interest will be discontinued and the security will be placed on non-accrual status. Securities normally are not placed on non-accrual status if the servicer continues to advance on the delinquent mortgage loans in the security.

Contingencies

In the normal course of business, there are various lawsuits, claims, and other contingencies pending against the Company. In accordance with ASC Topic 450, we evaluate whether to establish provisions for estimated losses from those matters. Although the ultimate outcome of the various matters cannot be ascertained at this point, it is the opinion of management, after consultation with counsel, that the resolution of the foregoing matters will not have a material adverse effect on the Company's consolidated financial condition or liquidity. The resolution of any such matters could, however, have a material effect on the consolidated results of operations or cash flows in a given future reporting period. Please refer to Note 12 for details on the most significant matters currently pending.

Recent Accounting Pronouncements

In April 2011, FASB issued Accounting Standards Update ("ASU" or "Update") No. 2011-02, which amends ASC Topic 310 to clarify the guidance on evaluating whether a restructuring constitutes a troubled debt restructuring. Specifically, a creditor must separately conclude that the restructuring constitutes a concession and that the debtor is experiencing financial difficulties. If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. A temporary or permanent increase in the contractual interest rate does not preclude the restructuring from being considered a concession because the contractual interest rate on the restructured debt may still be below the market interest rate for new debt with similar characteristics. If the creditor determines that it has granted a concession to the debtor, it must then evaluate whether a debtor is experiencing financial difficulties. The amendments clarify that a debtor does not have to be currently in payment default in order to be considered as experiencing financial difficulties. Additionally, a creditor should evaluate whether it is probable that the debtor will be in payment default on any of its debt in the foreseeable future without the modification. The amendments in this Update became effective for the first interim or annual reporting period beginning on or after June 15, 2011 and should be applied retrospectively to the beginning of the annual period of adoption.As a result of its retrospective application, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. An entity should disclose the total amount of receivables and the allowance for credit losses as of the end of the period of adoption related to those

receivables that are newly considered impaired under ASC Topic 310 for which impairment was previously measured under ASC Topic 450. In addition, ASU No. 2011-02 requires an entity to disclose the information required by ASU No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which was subsequently deferred temporarily by ASU No. 2011-01. Management has evaluated these amendments and does not believe that they have had a material impact on the Company's financial condition or results of operations.

In April 2011, FASB issued ASU No. 2011-03 to improve the accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASC Topic 860 prescribes when an entity may or may not recognize a sale upon transfer of financial assets subject to repurchase agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred financial assets. Previously, under ASC Topic 860, the transferor was required to have the ability to repurchase the same or substantially the same assets in order to assert that it has maintained effective control over the transferred assets. ASU No. 2011-03 removes the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, and also

removes the collateral maintenance implementation guidance related to that criterion. The FASB concluded that the assessment of effective control should focus on a transferor's contractual rights and obligations with respect to transferred financial assets, not on whether the transferor has the practical ability to perform in accordance with those rights or obligations. These amendments are effective for the first interim or annual reporting period beginning on or after December 15, 2011 and are to be applied prospectively. Management has evaluated these amendments and does not believe that they will have a material impact on the Company's financial condition or results of operations.

In May 2011, FASB issued ASU No. 2011-04 to amend ASC Topic 820 to clarify the FASB's intent about the application of existing fair value measurement and disclosure requirements as well as to change certain principles or requirements for measuring fair value or disclosing information about fair value measurements. One of its amendments which will apply to the Company is the disclosure of quantitative information about the unobservable inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy. In addition, the amendments will require more information from the Company about the valuation processes used by the reporting entity for fair value measurements categorized within Level 3 and the sensitivity of those measurements to changes in unobservable inputs. These amendments (and others included in the Update which are not discussed here as they are not applicable to the Company) are effective during interim and annual reporting periods beginning after December 15, 2011 and are to be applied prospectively. Early application by public entities is not permitted. Management has evaluated these amendments and does not believe that they will have a material impact on the Company's financial condition or results of operations.

NOTE 2 – NET INCOME PER COMMON SHARE

Net income per common share is presented on both a basic and diluted basis. Diluted net income per common share assumes the exercise of stock options using the treasury stock method, and for the three and nine months ended September 30, 2010 the conversion of the Company's formerly outstanding convertible preferred stock into common stock using the two-class method, but only if these items are dilutive. Each share of Series D preferred stock was convertible into one share of common stock. The following tables reconcile the numerator and denominator for both basic and diluted net income per common share:

	Three Months Ended September 30,			
	2011		2010	
	Income	Weighted-Average Common Shares (1)	Income	Weighted-Average Common Shares (1)
Net income	$1,532		$7,022	
Preferred stock dividends	—		(1,056)	
Net income to common shareholders	$1,532	40,353,219	$5,966	17,230,410
Effect of dilutive items	—	82	1,056	4,226,862
Diluted	$1,532	40,353,301	$7,022	21,457,272
Net income per common share:				
Basic		$ 0.04		$0.35
Diluted (1)		$ 0.04		$0.33
Components of dilutive items:				
Convertible preferred stock	$—	—	$1,056	4,221,387
Stock options	—	82	—	5,475
	$—	82	$1,056	4,226,862

(1)

For the three months ended September 30, 2011, the calculation of diluted net income per common share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

	Nine Months Ended September 30,			
	2011		2010	
	Income	Weighted-Average Common Shares [1]	Income	Weighted-Average Common Shares [1]
Net income	$25,406		$19,826	
Preferred stock dividends	—		(3,061)	
Net income to common shareholders	25,406	37,972,766	16,765	15,531,847
Effect of dilutive items	—	1,183	3,061	4,225,145
Diluted	$25,406	$ 37,973,949	$19,826	19,756,992
Net income per common share:				
Basic		$ 0.67		$ 1.08
Diluted [1]		$ 0.67		$ 1.00
Components of dilutive items:				
Convertible preferred stock	$—	—	$3,061	4,221,387
Stock options	—	1,183	—	3,758
	$—	1,183	$3,061	4,225,145

(1) For the nine months ended September 30, 2011 and September 30, 2010, the calculation of diluted net income per common share excludes the effects of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

NOTE 3 – AGENCY MBS

The following table presents the components of the Company's investment in Agency MBS as of September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
	RMBS	CMBS	Total	RMBS	CMBS	Total
Principal/par value	$1,619,518	$270,760	$1,890,278	$937,376	$190,511	$1,127,887
Unamortized premium	92,188	73,318	165,506	43,776	18,757	62,533
Unamortized discount	(1)	—	(1)	(36)	—	(36)
Amortized cost	1,711,705	344,078	2,055,783	981,116	209,268	1,190,384
Unrealized gains:						
Available for sale	11,607	10,946	22,553	8,266	567	8,833
Trading	—	1,819	1,819	—	—	—
Unrealized losses:						
Available for sale	(7,091)	(954)	(8,045)	(3,371)	(3,267)	(6,638)
Trading	—	—	—	—	—	—
Fair value	$1,716,221	$355,889	$2,072,110	$986,011	$206,568	$1,192,579
Weighted average coupon based on par value	4.55%	5.14%	5.12%	4.46%	5.41%	4.62%

The Company has purchased $1,189,862 of Agency RMBS and $143,747 of Agency CMBS since December 31, 2010. Included in the table above are Agency CMBS with a par value of $24,776 that were pending settlement as of September 30, 2011.

As of September 30, 2011, the amortized cost and fair value of Agency CMBS designated as trading securities was $27,276 and $29,095, respectively, with the remainder of the Company's Agency CMBS and Agency RMBS designated as available-for-sale. The Company did not hold any Agency CMBS or RMBS designated as trading securities as of December 31, 2010. The Company has not sold any of its trading securities purchased during the nine months ended September 30, 2011, and has recognized

a net unrealized gain for the three and nine months ended September 30, 2011 of $744 and $1,819, respectively, related to their changes in fair value, which is included within “fair value adjustments, net” in its consolidated statements of income. The Company also has derivatives designated as trading instruments, and the changes in their fair value are also included within "fair value adjustments, net". For the three and nine months ended September 30, 2011, the Company recognized a net unrealized loss of $(1,446) and $(2,649), respectively, related to these derivatives. Please refer to Note 7 for additional information on these derivatives designated as trading instruments.

A portion of the Company's Agency CMBS as reported in the table above as of September 30, 2011 are interest-only securities. The Company did not hold any Agency interest-only securities as of December 31, 2010. The table below presents the Company's Agency CMBS by security type as of September 30, 2011.

	September 30, 2011			
	Principal	Premium	Unrealized Gain (Loss)	Total
Principal and interest securities	$270,760	$21,646	$12,750	$305,156
Interest only securities [(1)]	—	51,672	(939)	50,733
Fair value of Agency CMBS	$270,760	$73,318	$11,811	$355,889

(1) The combined notional balance for the Agency interest-only securities is $1,498,210 as of September 30, 2011.

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NOTE 4 – NON-AGENCY MBS

The following table presents the components of the Company’s non-Agency MBS as of September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
	RMBS	CMBS	Total	RMBS	CMBS	Total
Principal/par value	$14,271	$357,644	$371,915	$16,101	$247,494	$263,595
Unamortized premium	—	39,006	39,006	138	5,352	5,490
Unamortized discount	(1,044)	(16,528)	(17,572)	(1,115)	(11,296)	(12,411)
Amortized cost	13,227	380,122	393,349	15,124	241,550	256,674
Unrealized gains	520	12,875	13,395	632	10,978	11,610
Unrealized losses	(826)	(2,213)	(3,039)	(348)	(580)	(928)
Fair value	$12,921	$390,784	$403,705	$15,408	$251,948	$267,356
Weighted average coupon based on par value	4.56%	6.01%	5.95%	4.54%	6.49%	6.37%

All of the Company’s non-Agency MBS are designated as available-for-sale and are comprised primarily of investment-grade rated securities with a fair value of $380,116 and $262,234 as of September 30, 2011 and December 31, 2010, respectively. The Company has purchased $154,413 of non-Agency CMBS since December 31, 2010, of which $20,000 are pending settlement as of September 30, 2011. The Company also has $3,000 of non-Agency RMBS pending settlement as of September 30, 2011. Pending non-Agency CMBS and RMBS purchases are included in the balances shown in the table above.

A portion of the Company's non-Agency CMBS as reported in the table above as of September 30, 2011 are interest-only securities. The Company did not hold any non-Agency interest-only securities as of December 31, 2010. The table below presents the Company's non-Agency CMBS by security type as of September 30, 2011.

	September 30, 2011			
	Principal	Net Premium	Unrealized Gain (Loss)	Total
Principal and interest securities	$357,644	$(12,312)	$10,421	$355,753
Interest only securities [(1)]	—	34,790	241	35,031
Fair value of non-Agency CMBS	$357,644	$22,478	$10,662	$390,784

(1) The combined notional balance for the non-Agency interest-only securities is $723,008 as of September 30, 2011.

NOTE 5 – SECURITIZED MORTGAGE LOANS, NET

All of the Company's securitized mortgage loans are pledged as collateral for its associated securitization financing bonds, which are discussed further in Note 9. Please also refer to Note 6 for disclosures related to impaired securitized mortgage loans and the related allowance for loans losses. The following table summarizes the components of securitized mortgage loans as of September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
	Commercial	Single-family	Total	Commercial	Single-family	Total
Principal/par value	$70,559	$48,866	$119,425	$99,432	$54,181	$153,613
FHBT[1]	1,162	—	1,162	3,455	—	3,455
Unamortized premium, net	—	793	793	—	884	884
Unamortized discount, net	(299)	—	(299)	(520)	—	(520)
Amortized cost	71,422	49,659	121,081	102,367	55,065	157,432
Allowance for loan losses	(2,173)	(208)	(2,381)	(4,200)	(270)	(4,470)
	$69,249	$49,451	$118,700	$98,167	$54,795	$152,962

(1) Funds held by trustees includes $905 and $3,306 as of September 30, 2011 and December 31, 2010, respectively, of cash and cash equivalents held by the trust for defeased commercial mortgage loans. These funds were paid by the borrower to the securitization trust pursuant to the contractual terms of the mortgage loan and represent replacement collateral for defeased loans. In accordance with the underlying agreements, cash payments are made by the securitization trust using these defeased amounts until the funds held for that particular defeased mortgage loan equal the scheduled principal balance of the original loan. At that point a final distribution is made to the trust as payment in full of the principal amount due on the loan.

The balance of the Company's securitized commercial mortgage loans has decreased since December 31, 2010 primarily due to principal payments, including amounts received on defeased loans, of $27,401. The Company's securitized commercial mortgage loans were originated principally in 1996 and 1997 and are collateralized by first deeds of trust on income producing properties. Approximately 78% of these securitized commercial mortgage loans are secured by multifamily properties. As of September 30, 2011 and December 31, 2010, the loan-to-value ratio based on original appraisal was 43% and 45%, respectively. The unpaid principal balance of the securitized commercial mortgage loans identified as seriously delinquent (60 or more days past due) and therefore on nonaccrual status is $15,121 as of September 30, 2011 compared to $14,089 as of December 31, 2010.

The balance of the Company's securitized single-family mortgage loans have decreased since December 31, 2010 due to principal payments on the loans of $5,254, of which 53% were unscheduled. These single-family mortgage loans are secured by first deeds of trust on residential real estate and were originated principally from 1992 to 1997. As of September 30, 2011 and December 31, 2010, the current loan-to-value ratio based on original appraisal was approximately 46% and 48%, respectively. The unpaid principal balance of the Company's securitized single-family mortgage loans identified as seriously delinquent as of September 30, 2011 is $3,549. The Company continues accruing interest on any seriously delinquent securitized single-family mortgage loan so long as the primary servicer continues to advance the interest and/or principal due on the loan.

NOTE 6 – ALLOWANCE FOR LOAN LOSSES

As discussed in Note 1, the Company estimates for currently existing and probable losses for its mortgage loans that are considered impaired. A loan does not have to be seriously delinquent (60 or more days past due) in order to be considered impaired. The following table presents certain information on impaired securitized commercial and single-family mortgage loans as of September 30, 2011 and December 31, 2010:

	September 30, 2011		December 31, 2010	
	Commercial	Single-family	Commercial	Single-family
Unpaid principal balance of impaired securitized loans	$4,770	$3,487	$18,219	$3,587
Basis adjustments related to impaired securitized loans	(3)	57	(65)	59
Amortized cost basis of impaired securitized loans	4,767	3,544	18,154	3,646
Allowance for loan losses	(2,173)	(208)	(4,200)	(270)
Investment in excess of allowance	$2,594	$3,336	$13,954	$3,376

The Company recognized $27 and $83 of interest income on impaired securitized commercial mortgage loans for the three and nine months ended September 30, 2011 compared to $135 and $416 of interest income for the three and nine months ended September 30, 2010. The Company recognized $49 and $146 of interest income on impaired securitized single-family mortgage loans for the three and nine months ended September 30, 2011 compared to $56 and $169 on impaired single-family mortgage loans for the three and nine months ended September 30, 2010.

The following table summarizes the aggregate activity for the portion of the allowance for loan losses that relates to the securitized mortgage loan portfolio for the periods indicated:

	Three Months Ended September 30,			
	2011		2010	
	Commercial	Single-family	Commercial	Single-family
Allowance at beginning of period	$3,069	$208	$4,085	$277
Provision for loan losses[1]	300	—	240	—
Credit losses, net of recoveries	(1,196)	—	(616)	(6)
Allowance at end of period[2]	$2,173	$208	$3,709	$271

(1) Activity shown for provision for loan losses for the three months ended September 30, 2010 excludes provision of $16 and credit losses of $(281) related to the Company’s unsecuritized mortgage loan portfolio.

(2) The amount of allowance related to the Company's unsecuritized mortgage loan portfolio is $0 as of September 30, 2011 and September 30, 2010.

	Nine Months Ended September 30,			
	2011		2010	
	Commercial	Single-family	Commercial	Single-family
Allowance at beginning of period	$4,200	$270	$3,935	$277
Provision for loan losses[1]	750	—	390	—
Credit losses, net of recoveries	(2,777)	(62)	(616)	(6)
Allowance at end of period[2]	$2,173	$208	$3,709	$271

(1) Activity shown for provision for loan losses for the nine months ended September 30, 2010 excludes provision of $185 and credit losses of $(281) related to the Company’s unsecuritized mortgage loan portfolio.

(2) The amount of allowance related to the Company's unsecuritized mortgage loan portfolio is $0 as of September 30, 2011 and September 30, 2010.

NOTE 7 – DERIVATIVES

Please see Note 1 for additional information related to the Company’s accounting policies for derivative instruments.

As of September 30, 2011 and December 31, 2010, the Company’s derivative financial instruments are comprised entirely of interest rate swaps, and are designated as either hedging instruments or trading instruments. With respect to hedging instruments, the Company’s objective for using interest rate swaps is to minimize its exposure to the risk of increased interest expense resulting from its existing and forecasted short-term, fixed-rate borrowings. The Company continuously borrows funds via sequential fixed-

rate, short-term repurchase agreement borrowings. As each fixed-rate repurchase agreement matures, it is replaced with new fixed-rate agreements based on the market interest rate in effect at the time of such replacement. This sequential rollover borrowing program creates a variable interest expense pattern. The changes in the cash flows of the interest rate swaps are expected to be highly effective at offsetting changes in the interest portion of the cash flows expected to be paid at maturity of each borrowing.

With respect to trading instruments, the Company's objective for using interest rate swaps is to offset the changes in market value of its investments also designated as trading. See Note 3 for information related to the investments designated as trading.

The tables below summarize information about the Company's derivative financial instruments on the balance sheet as of the dates indicated:

As of September 30, 2011

Accounting Designation	Balance Sheet Location	Fair Value	Cumulative Notional Amount	Weighted-average Fixed Rate Swapped	
Hedging instruments	Derivative assets	$—	$—	—	%
Hedging instruments	Derivative liabilities	$26,544	$995,000	1.55	%
Trading instruments	Derivative liabilities	2,294	27,000	2.88	%
		$28,838			

As of December 31, 2010

Accounting Designation	Balance Sheet Location	Fair Value	Cumulative Notional Amount	Weighted-average Fixed Rate Swapped	
Hedging instruments	Derivative assets	$692	$100,000	1.89	%
Hedging instruments	Derivative liabilities	$(3,532)	$245,000	1.58	%

As of September 30, 2011, the Company had margin requirements with its swap counterparties for these interest rate swaps for which Agency MBS with a fair value of $30,691 have been posted as collateral. The following table summarizes the contractual maturities remaining for the Company's outstanding interest rate swap agreements as of September 30, 2011:

Remaining Maturity	Notional Amount: Trading	Notional Amount: Hedging	Notional Amount: Total	Number of Swaps	Weighted-Average Fixed Rate Swapped	
0-12 months	$—	$100,000	$100,000	2	1.02	%
13-36 months	—	510,000	510,000	9	1.26	%
37-60 months	5,000	320,000	325,000	10	2.07	%
Over 60 months	22,000	65,000	87,000	5	2.28	%
	$27,000	$995,000	$1,022,000	26	1.58	%

The table below presents the effect of the derivatives designated as trading instruments on the Company's consolidated statements of income for the periods indicated.

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Type of Derivative Designated as Trading	Location of Amount Recognized in Net Income	Amount of Loss Recognized in Net Income For the Three Months Ended September 30, 2011	September 30, 2010	Amount of Loss Recognized in Net Income For the Nine Months Ended September 30, 2011	September 30, 2010
Interest rate swaps	Fair value adjustments, net	$1,075	$—	$2,294	$—

The table below presents the effect of the derivatives designated as hedging instruments on the Company's consolidated statement of comprehensive income for the periods indicated:

Type of Derivative Designated as Cash Flow Hedge	Amount of (Gain) Loss Recognized in OCI (Effective Portion)	Location of Amount Reclassified from OCI into Net Income (Effective Portion)	Amount Reclassified from OCI into Net Income (Effective Portion)	Location of (Gain) Loss Recognized in Net Income (Ineffective Portion)	Amount of (Gain) Loss Recognized in Net Income Ineffective Portion)
For the three months ended September 30, 2011:					
Interest rate swaps	$18,251	Interest expense	$3,383	Other income, net	$31
For the three months ended September 30, 2010:					
Interest rate swaps	$2,699	Interest expense	$651	Other income, net	$6
For the nine months ended September 30, 2011:					
Interest rate swaps	$31,974	Interest expense	$8,325	Other income, net	$55
For the nine months ended September 30, 2010:					
Interest rate swaps	$7,587	Interest expense	$1,706	Other income, net	$15

The table below presents a rollforward of the activity in the Company's AOCI related to its derivatives designated as hedging instruments for the periods presented:

	2011	2010
Balance as of January 1,	$(2,820)	$1,008
Change in fair value of interest rate swaps	(31,974)	(7,587)
Reclassification adjustment for amounts included in statement of income	8,325	1,706
Balance as of September 30,	$(26,469)	$(4,873)

The Company estimates that an additional $10,554 related to its derivatives designated as hedging instruments will be recognized as an increase to interest expense during the next 12 months.

The interest rate swap agreements the Company has with its derivative counterparties contain various covenants related to the Company's credit risk. Specifically, if the Company defaults on any of its indebtedness, including those circumstances whereby repayment of the indebtedness has not been accelerated by the lender, or is declared in default of any of its covenants with any counterparty, then the Company could also be declared in default of its derivative obligations. The covenant violation by the Company as of September 30, 2011, which is discussed in Note 8, did not

effect any of its derivative obligations. Additionally, the agreements outstanding with our derivative counterparties allow those counterparties to require settlement of its outstanding derivative transactions if the Company fails to earn GAAP net income greater than one dollar as measured on a rolling two quarter basis. These interest rate agreements also contain provisions whereby, if the Company fails to maintain a minimum net amount of shareholders' equity, then the Company may be declared in default on its derivative obligations. As of September 30, 2011, the Company had derivatives in a net liability position with its derivative counterparties totaling $29,325, inclusive of accrued interest but excluding any adjustment for nonperformance risk, for which it had pledged Agency MBS with a fair value of $30,691 as collateral. If the Company had breached any of these agreements as of September 30, 2011, it could have been required to settle those derivatives at their estimated termination value of $29,325.

NOTE 8 – REPURCHASE AGREEMENTS

The Company uses repurchase agreements, which are recourse to the Company, to finance certain of its investments. The following tables present the components of the Company’s repurchase agreements as of September 30, 2011 and December 31, 2010 by the type of securities collateralizing the repurchase agreement:

	September 30, 2011			
Collateral Type	Balance	Weighted Average Rate		Fair Value of Collateral Pledged
Agency RMBS	$1,542,593	0.28	%	$1,606,539
Agency CMBS	225,856	0.43	%	241,713
Non-Agency RMBS	7,048	1.32	%	8,205
Non-Agency CMBS	235,804	1.22	%	278,046
Securitization financing bonds (see Note 9)	42,385	1.16	%	48,988
	$2,053,686	0.43	%	$2,183,491

	December 31, 2010			
Collateral Type	Balance	Weighted Average Rate		Fair Value of Collateral Pledged
Agency RMBS	$869,537	0.33	%	$908,375
Agency CMBS	150,178	0.31	%	161,143
Non-Agency RMBS	12,126	1.29	%	13,628
Non-Agency CMBS	135,143	1.31	%	164,871
Securitization financing bonds (see Note 9)	67,199	1.36	%	79,080
	$1,234,183	0.50	%	$1,327,097

The combined weighted average term to original maturity for the Company’s repurchase agreements was 45 days as of September 30, 2011 and 50 days as of December 31, 2010. The following table provides a summary of the original maturity as of September 30, 2011 and December 31, 2010:

Original Maturity	September 30, 2011	December 31, 2010
30 days or less	$1,177,698	$478,848
31 to 60 days	347,951	372,702
61 to 90 days	81,226	202,569
Greater than 90 days	446,811	180,064
	$2,053,686	$1,234,183

The Company's maximum amount of equity at risk (equal to the fair value of the collateral pledged in excess of the amount due) was $42,525 with Bank of America with whom the Company had repurchase agreements of $281,671 outstanding as of September 30, 2011. The maximum amount of equity at risk with all other counterparties did not exceed 10% of the Company's shareholders' equity as of September 30, 2011.

Our repurchase agreement counterparties require us to comply with various customary operating and financial covenants, including, but not limited to, minimum net worth, minimum liquidity, and leverage requirements as well as maintaining our REIT status. In addition, some of the covenants contain cross default features, whereby default under

one agreement simultaneously causes default under another agreement. To the extent that we fail to comply with the covenants contained in our financing agreements or are otherwise found to be in default under the terms of such agreements, we could be restricted from paying dividends

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or from engaging in other transactions that are necessary for us to maintain our REIT status. As of September 30, 2011, one of the Company's repurchase agreement counterparties required that the Company's total liabilities not exceed six times its shareholders' equity. Due to the Company's accrual of its litigation settlement costs (see Note 12), the Company failed to comply with this covenant as of September 30, 2011. The Company and the counterparty have entered into an amendment to increase the limit to seven times its shareholders' equity. No obligations were accelerated in connection with this covenant violation, and no cross-default provisions under other agreements were triggered as a result of the breach of this covenant. The Company was in compliance with all remaining covenants as of September 30, 2011. Please refer to "Liquidity and Capital Resources" within Item 2 of this Quarterly Report on Form 10-Q for additional information related to these covenants.

NOTE 9 – NON-RECOURSE COLLATERIZED FINANCING

The following table summarizes information about the Company’s non-recourse collateralized financing for the periods indicated:

		September 30, 2011		
	Interest Rate	Weighted Average Life Remaining (in years)	Balance Outstanding	Value of Collateral
Securitization financing:				
Secured by non-Agency CMBS	6.2% fixed	2.1	15,000	16,673
Secured by single-family mortgage loans	1-month LIBOR plus 0.30%	3.3	19,316	20,213
TALF financing:[1]				
Secured by non-Agency CMBS	2.7% fixed	1.4	50,486	64,718
Unamortized net bond premium and deferred costs			(789)	n/a
			$84,013	$101,604

		December 31, 2010		
	Interest Rate	Weighted Average Life Remaining (in years)	Balance Outstanding	Value of Collateral
Securitization financing:				
Secured by commercial mortgage loans	7.2% fixed	3.7	$23,669	$43,440
Secured by non-Agency CMBS	6.2% fixed	3.4	15,000	16,754
Secured by single-family mortgage loans	1-month LIBOR plus 0.30%	3.4	21,183	21,889
TALF financing:[1]				
Secured by non-Agency CMBS	2.7% fixed	2.2	50,713	64,097
Unamortized net bond premium and deferred costs			(3,460)	n/a
			$107,105	$146,180

(1) Financing provided by the Federal Reserve Bank of New York under its Term Asset-Backed Securities Loan Facility (“TALF”).

The Company has redeemed securitization bonds in the past, and in certain instances, the Company has kept the bond outstanding and used it as collateral for additional repurchase agreement borrowings. These additional borrowings may have been used to either finance the bond redemption or to purchase additional investments. Although these

bonds are legally outstanding, the balances are eliminated in consolidation because the issuing trust is included in the Company's consolidated financial statements.
The following table summarizes information regarding all of the Company's redeemed bonds that have an outstanding balance as of September 30, 2011:

Collateral Type	Par Value Outstanding	Fair Value	Repurchase Agreement Balance
Single-family mortgage loans	$22,297	$19,728	$17,386
Commercial mortgage loans	52,835	29,260	24,999
	$75,132	$48,988	$42,385

NOTE 10 – FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company utilizes fair value measurements at various levels within the hierarchy established by ASC Topic 820 for certain of its assets and liabilities. The three levels of valuation hierarchy established by ASC Topic 820 are as follows:

- Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.
- Level 2 – Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life. The Company's fair valued assets and liabilities that are generally included in this category are Agency MBS, certain non-Agency CMBS, and derivatives.
- Level 3 – Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model. Generally, the Company's assets and liabilities carried at fair value and included in this category are non-Agency MBS.

The following table presents the fair value of the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2011, segregated by the hierarchy level of the fair value estimate:

		Fair Value Measurements		
	Fair Value	Level 1	Level 2	Level 3
Assets:				
Agency MBS	$2,072,110	$—	$2,072,110	$—
Non-Agency MBS:				
CMBS	390,784	—	255,823	134,961
RMBS	12,921	—	5,474	7,447
Other investments	25	—	—	25
Total assets carried at fair value	$2,475,840	$—	$2,333,407	$142,433
Liabilities:				
Derivative liabilities	$28,838	$—	$28,838	$—
Total liabilities carried at fair value	$28,838	$—	$28,838	$—

The Company's Agency MBS, as well a portion of its non-Agency CMBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple dealer quotes and thus are considered Level 2 fair value measurements.

The Company's remaining non-Agency CMBS and non-Agency RMBS are comprised of securities for which there are not substantially similar securities that trade frequently. As such, the Company determines the fair value of those securities by discounting the estimated future cash flows derived from pricing models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant inputs into those pricing models are Level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security's credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, credit enhancement, as well as certain other relevant information. The following tables present the activity of the instruments fair valued at Level 3 for the three and nine months ended September 30, 2011:

	Level 3 Fair Values			
	Non-Agency CMBS	Non-Agency RMBS	Other	Total assets
Balance as of June 30, 2011	$136,761	$4,722	$25	$141,508
Purchases	2,956	3,000	—	5,956
Sales	—	—	—	—
Total unrealized losses:				
Included in other comprehensive income	(997)	27	—	(970)
Principal payments	(3,493)	(311)	—	(3,804)
Amortization	(266)	9	—	(257)
Balance as of September 30, 2011	$134,961	$7,447	$25	$142,433

	Level 3 Fair Values			
	Non-Agency CMBS	Non-Agency RMBS	Other	Total assets
Balance as of January 1, 2011	$146,671	$9,307	$25	$156,003
Purchases	3,054	3,000	—	6,054
Sales	—	(3,765)	—	(3,765)
Total unrealized losses:				
Included in other comprehensive income	(431)	37	—	(394)
Principal payments	(13,526)	(1,139)	—	(14,665)
Amortization	(807)	7	—	(800)
Balance as of September 30, 2011	$134,961	$7,447	$25	$142,433

The following table presents the recorded basis and estimated fair values of the Company’s financial instruments as of September 30, 2011 and December 31, 2010:

	September 30, 2011		December 31, 2010	
	Recorded Basis	Fair Value	Recorded Basis	Fair Value
Assets:				
Agency MBS	$2,072,110	$2,072,110	$1,192,579	$1,192,579
Non-Agency CMBS	390,784	390,784	251,948	251,948
Non-Agency RMBS	12,921	12,921	15,408	15,408
Securitized mortgage loans, net	118,700	108,030	152,962	142,177
Other investments	1,059	988	1,229	1,112
Derivative assets	—	—	692	692
Liabilities:				
Repurchase agreements	$2,053,686	$2,053,686	$1,234,183	$1,234,183
Non-recourse collateralized financing	84,013	84,425	107,105	109,395
Derivative liabilities	28,838	28,838	3,532	3,532

There were no assets or liabilities which were measured at fair value on a non-recurring basis as of September 30, 2011 or December 31, 2010.

The following table presents certain information for Agency MBS and non-Agency MBS that were in an unrealized loss position as of September 30, 2011 and December 31, 2010:

	September 30, 2011		December 31, 2010	
	FairValue	Unrealized Loss	FairValue	Unrealized Loss
Unrealized loss position for:				
Less than one year:				
Agency MBS	$820,973	$6,930	$695,854	$6,638
Non-Agency MBS	118,222	2,668	45,602	592
One year or more:				
Agency MBS	72,573	1,124	—	—
Non-Agency MBS	3,084	371	3,494	337
	$1,014,852	$11,093	$744,950	$7,567

Because the principal and interest related to Agency MBS are guaranteed by issuers who have the implicit guarantee of the U.S. government, the Company does not consider any of the unrealized losses on its Agency MBS to be credit related. The Company assesses its ability to hold an Agency MBS with an unrealized loss until the recovery in its value. This assessment is based on the amount of the unrealized loss and significance of the related investment as well as the Company's current leverage and anticipated liquidity. Based on this analysis, the Company has determined that the unrealized losses on its Agency MBS as of September 30, 2011 are temporary.

The Company reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an other-than-temporary impairment. The evaluation includes a review of the credit ratings of these MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows which include projected losses. The Company performed this evaluation for the non-Agency MBS in an unrealized loss position as of September 30, 2011 and has determined that there have not been any adverse changes in the timing or amount of estimated future cash flows that necessitate a recognition of other-than-temporary impairment amounts as of September 30, 2011.

NOTE 11 – SHAREHOLDERS' EQUITY

Common Stock

The Company has recently implemented a Dividend Reinvestment and Share Purchase Plan ("DRIP") which allows registered shareholders to automatically reinvest some or all of their quarterly dividends in shares of the Company's stock and provides an opportunity for investors to purchase shares of the Company's stock, potentially at a discount to the prevailing market price. The Company declared a third quarter common stock dividend of $0.27 per share payable on October 31, 2011 to shareholders of record as of September 30, 2011, however there is no Dividend Reinvestment Discount for third quarter dividends reinvested through the DRIP.

The Company also has a continuous equity placement program ("EPP") whereby the Company may offer and sell through its sales agent shares of its common stock in negotiated transactions or transactions that are deemed to be "at the market offerings," as defined in Rule 415 under the 1933 Act, including sales made directly on the New York Stock Exchange or sales made to or through a market maker other than on an exchange. During the nine months ended September 30, 2011, the Company has received proceeds of $4,332, net of broker sales commission, for 409,237 shares of common stock sold under this program at an average price of $10.75. The Company originally registered 5,000,000 shares under the EPP, and as of September 30, 2011, has 538,147 remaining shares to be issued under the EPP.

During the nine months ended September 30, 2011, the Company closed a public offering of 9,200,000 shares of its common stock, including 1,200,000 shares pursuant to an overallotment option that was fully exercised by the underwriters, at a public offering price of $10.35 per share for total net proceeds of $90,459 after deduction of

underwriting discounts, commissions, and expenses. The Company has used these proceeds to acquire additional investments consistent with its investment policy.

The following table presents a summary of the changes in the number of common shares outstanding for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Balance at beginning of period	40,343,159	15,168,742	30,342,897	13,931,512
Common stock issued under EPP	—	3,540,500	409,237	4,680,700
Common stock issued under DRIP	2,111	—	2,111	—
Common stock issued via public offering	—	—	9,200,000	—
Common stock redeemed under 2004 Stock and Incentive Plan	—	—	15,000	50,000
Common stock issued under 2009 Stock and Incentive Plan	35,006	—	411,031	47,030
Conversion of preferred stock to common stock	—	152	—	152
Balance at end of period	40,380,276	18,709,394	40,380,276	18,709,394

Incentive Plans. Pursuant to the Company’s 2009 Stock and Incentive Plan, the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights (“SARs”), dividend equivalent rights, performance shares, and restricted stock units. Of the 2,500,000 shares of common stock authorized for issuance under this plan, 2,041,939 shares remain available as of September 30, 2011. Although the Company is no longer issuing stock-based compensation under its 2004 Stock Incentive Plan, there are stock options, SARs, and restricted stock still outstanding (and exercisable if vested) thereunder as of September 30, 2011.

Stock options and restricted stock that the Company has issued may be settled only in shares of its common stock, and therefore are treated as equity awards with their fair value measured at the grant date as required by ASC Topic 718. The compensation cost related to all stock options has been expensed in prior periods. As of September 30, 2011, the fair value of the Company’s outstanding restricted stock remaining to be amortized into net income is $2,979.

The Company did not grant any stock options during the three and nine months ended September 30, 2011 or September 30, 2010, and there were no forfeitures of its outstanding stock options for those same periods. There were no options exercised during the three months ended September 30, 2011 or September 30, 2010, and 15,000 options were exercised at a weighted average price of $7.42 during the nine months ended September 30, 2011 compared to 50,000 options exercised at a weighted average price of $8.45 during the nine months ended September 30, 2010. As of September 30, 2011, there are 30,000 options remaining to be exercised at a weighted average price of $9.42.

The following table presents a rollforward of the restricted stock activity for the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Restricted stock at beginning of period	330,500	25,000	25,000	32,500
Restricted stock granted	35,006	—	358,006	10,000
Restricted stock vested	—	—	(17,500)	(17,500)
Restricted stock outstanding at end of period	365,506	25,000	365,506	25,000

SARs issued by the Company may be settled only in cash, and therefore have been treated as liability awards with their fair value measured at the grant date and remeasured at the end of each reporting period as required by ASC Topic 718. As of September 30, 2011 and December 31, 2010, the fair value of the Company’s outstanding SARs of $131 and $492, respectively, are recorded as liabilities on its consolidated balance sheet for the respective periods. The fair value of SARs is estimated using the Black-Scholes option valuation model based upon the

assumptions in the table below.

	September 30, 2011	December 31, 2010
Expected volatility	22.8%-34.2%	16.2%-18.6%
Weighted-average volatility	28.8 %	17.3 %
Estimated dividend yield	13.3%-14.2%	9.9%-10.3%
Expected term (in months)	7	12
Weighted-average risk-free rate	0.57 %	0.81 %
Range of risk-free rates	0.4%-0.9%	0.4%-1.3%

As of September 30, 2011, the Company has 136,875 SARs outstanding, all of which are vested and exercisable at a weighted average price of $7.31 at any time prior to their expiration dates. The weighted average remaining contractual term on these outstanding SARs as of September 30, 2011 is 15 months, and 60,000 of the outstanding SARs are set to expire if they are not exercised on or before December 31, 2011. As of September 30, 2010, there were 136,875 SARs outstanding at a weighted average price of $7.31, and 116,875 of those SARs were vested and exercisable at that time at a weighted average price of $7.35. No SARs were granted, forfeited, or exercised during the three and nine months ended September 30, 2011. During the three and nine months ended September 30, 2010, no SARs were granted or forfeited and approximately 141,000 SARs were exercised at a weighted average price of $7.24.

Total stock-based compensation expense recognized by the Company for the three and nine months ended September 30, 2011 is $139 and $492, respectively, compared to $395 and $558 for the three and nine months ended September 30, 2010, respectively.

Additional Paid-In Capital

The following table presents a rollforward of the Company's changes in additional paid-in capital for the nine months ended September 30, 2011:

	Additional Paid-In Capital
Balance as of January 1, 2011	$538,304
Common stock issuances:	
DRIP issuances	20
EPP issuance	4,284
Public offering	90,343
Incentive plans	656
Amortization of restricted stock	852
Capitalized expenses	(142)
Balance as of September 30, 2011	$634,317

Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of September 30, 2011 and December 31, 2010 is comprised of the following items:

	September 30, 2011	December 31, 2010
Available for sale investments:		
Unrealized gains	$35,948	$20,443
Unrealized losses	(11,084)	(7,566)
	24,864	12,877
Hedging instruments:		
Unrealized gains	—	692
Unrealized losses	(26,469)	(3,512)
	(26,469)	(2,820)
Accumulated other comprehensive (loss) income	$(1,605)	$10,057

Due to the Company's REIT status, the items comprising other comprehensive income do not have related tax effects.

Accumulated Deficit

The following table presents a rollforward of the Company's accumulated deficit for the nine months ended September 30, 2011:

	Accumulated Deficit
Balance as of January 1, 2011	$(256,307)
Net income for the quarter ended March 31, 2011	10,280
Dividends declared ($0.27 per share) for the quarter ended March 31, 2011	(10,886)
Net income for the quarter ended June 30, 2011	13,594
Dividends declared ($0.27 per share) for the quarter ended June 30, 2011	(10,892)
Net income for the quarter ended September 30, 2011	1,532
Dividends declared ($0.27 per share) for the quarter ended September 30, 2011	(10,903)
Balance as of September 30, 2011	$(263,582)

NOTE 12 – COMMITMENTS AND CONTINGENCIES

The Company and its subsidiaries are parties to various legal proceedings, including those described below. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings, including those described below, will not have a material adverse effect on the Company's consolidated financial condition or liquidity. However, the resolution of any of the proceedings described below could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

One of the Company's subsidiaries, GLS Capital, Inc. ("GLS"), and the County of Allegheny, Pennsylvania are defendants in a class action lawsuit filed in 1997 in the Court of Common Pleas of Allegheny County, Pennsylvania (the "Court"). Between 1995 and 1997, GLS purchased from Allegheny County delinquent property tax receivables for properties located in the County. The plaintiffs in this matter have alleged that GLS improperly recovered or sought recovery for certain fees, costs, interest, and attorneys' fees and expenses in connection with GLS' collection of the property tax receivables. The Court granted class action status in this matter in August 2007. In February 2011, as a result of motions filed by GLS, the Court refined the class to include only owners of real estate in the County of Allegheny who paid an attorneys' fee between 1996 and 2003 in connection with the forced collection of delinquent

Allegheny County property taxes. As a result, the Court has dismissed all claims against GLS with the exception of whether attorneys' fees and related expenses charged by GLS in connection with the collection of the receivables was reasonable. Such attorneys' fees and related expenses were assessed pursuant to prevailing County ordinance. Plaintiffs have not enumerated their damages in this matter. No trial date has been set.

On April 1, 2011 in the matter styled Basic Capital Management et al (the “BCM Plaintiffs”) versus Dynex Commercial,

Inc. (“DCI”) and Dynex Capital, Inc. (DCI and the Company, together, the “Respondents”), the Supreme Court of Texas partially reversed the Fifth Court of Appeals at Dallas (the “Court of Appeals”) and remanded the case back to the Court of Appeals for consideration of arguments not previously reached by the Court of Appeals. The appeal to the Supreme Court of Texas was filed by the BCM Plaintiffs. Dynex Capital and DCI have filed a motion to reconsider with the Supreme Court of Texas. The Company anticipates that the Supreme court will grant or deny its motion to reconsider by the end of 2011. For further discussion of this litigation, see the Company's Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission on March 16, 2011.

Dynex Capital, Inc., MERIT Securities Corporation, a subsidiary ("MERIT"), and the former President/Chief Executive Officer and current Chief Operating Officer/Chief Financial Officer of Dynex Capital, Inc., (together, the "Defendants") are defendants in a class action brought by the Teamsters Local 445 Freight Division Pension Fund (the "Teamsters") in the United States District Court for the Southern District of New York (the "District Court"). The original complaint, which was filed on February 7, 2005, alleged violations of the federal securities laws and was purportedly filed on behalf of purchasers between February 2000 and May 2004 of MERIT Series 12-1 and MERIT Series 13 securitization financing bonds (the "Bonds"), which are collateralized by manufactured housing loans. After a series of rulings and an eventual dismissal by the District Court, the Teamsters filed an amended complaint on August 6, 2008, essentially restating the same allegations as the original complaint and adding the Company’s former President/Chief Executive Officer and current Chief Operating Officer/Chief Financial Officer as defendants. The Teamsters seek unspecified damages and allege, among other things, fraud and misrepresentation in connection with the issuance of and subsequent reporting related to the Bonds. On March 7, 2011, the District Court granted the Teamsters' motion to certify the class for this action.

In September, 2011, the Defendants entered into a memorandum of understanding, reflecting an agreement in principle to settle all claims asserted in this matter. The memorandum of understanding sets forth terms of a proposed settlement whereby the Company would pay $7,500 into an escrow account following the negotiation and execution of a definitive settlement agreement and preliminary approval by the Court. The disbursement of the escrowed payment will be subject to negotiation and execution of a definitive settlement agreement, notice to the class, and final approval by the Court, in addition to any other conditions contained in the definitive settlement agreement. The Company continues to deny that it violated any federal securities laws and has agreed in principle to this settlement solely to eliminate the expense, burden, and uncertainty of the litigation.

For further discussion of this litigation, see the Company's Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission on March 16, 2011 and the Quarterly Reports on Form 10-Q for the three months ended March 31, 2011 and June 30, 2011.

NOTE 13 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Quarterly Report on Form 10-Q was filed with the SEC and made available to the public and has determined that there have been no significant events or circumstances that qualify as recognized or nonrecognized “subsequent events” as defined by ASC Topic 855.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis is provided to increase understanding of, and should be read in conjunction with, our unaudited consolidated financial statements and accompanying notes included in this Quarterly Report on Form 10-Q and our audited Annual Report on Form 10-K for the year ended December 31, 2010. References herein to "Dynex," the "company," "we," "us," and "our" include Dynex Capital, Inc. and its consolidated subsidiaries, unless the context otherwise requires. In addition to current and historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future business, financial condition or results of operations. For a description of certain factors that may have a significant impact on our future business, financial condition or results of operations, see "Forward-Looking Statements" at the end of this discussion and analysis.

EXECUTIVE OVERVIEW

Company Overview

We are an internally managed real estate investment trust, or REIT, which invests in mortgage assets on a leveraged basis. Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders through regular quarterly dividends and through capital appreciation.

We were formed in 1987 and commenced operations in 1988. Beginning with our inception through 2000, our operations largely consisted of originating and securitizing various types of loans, principally single-family and commercial mortgage loans and manufactured housing loans. Since 2000, we have been an investor in Agency and non-Agency mortgage-backed securities ("MBS"), and we are no longer originating or securitizing mortgage loans.

Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. Our investment strategy as approved by our Board of Directors is a diversified investment strategy that targets higher credit quality, shorter duration investments in Agency MBS and non-Agency MBS. Investments considered to be of higher credit quality have less or limited exposure to loss of principal while investments which have shorter durations have less exposure to changes in interest rates.

Agency MBS consist of residential MBS ("RMBS") and commercial MBS ("CMBS"), which come with a guaranty of payment by the U.S. government or a U.S. government-sponsored entity such as Fannie Mae and Freddie Mac. Non-Agency MBS (also consisting of RMBS and CMBS) have no such guaranty of payment. We currently target an overall investment portfolio composition of 50%-70% in Agency MBS with the balance in non-Agency MBS and securitized mortgage loans. Our securitized mortgage loans are loans which were originated and securitized by us during the 1990s.

As of September 30, 2011, our Agency MBS constituted 80% of our investment portfolio. As of June 30, 2011, our Agency MBS constituted 84% of our investment portfolio. We are currently above our targeted Agency MBS portfolio composition as a result of the deployment of substantially all of the equity capital raised by the Company in the first quarter of 2011 in Agency MBS. Over the balance of the year, we expect to reduce our overall Agency MBS investments as we move toward our targeted mix.

In executing our investment strategy, we seek to balance the various risks of owning mortgage assets, such as interest rate, credit, prepayment, and liquidity risk with the earnings opportunity on the investment. We believe our strategy

of investing in Agency and non-Agency mortgage assets provides superior diversification of these risks across our investment portfolio and therefore provides plentiful opportunities to generate attractive risk-adjusted returns while preserving our shareholders' capital.

Factors that Affect Our Results of Operations and Financial Condition

Our financial condition and results of operations are affected by a variety of factors, many of which are beyond our control. The success of our investment strategy and our results of operations and financial condition are impacted by a variety of industry and economic factors including interest rates, trends of interest rates, the steepness of interest rate curves, prepayment rates on our investments, competition for investments, economic conditions and their impact on the credit performance of our investments, and actions taken by the U.S. government, including the U.S. Federal Reserve and/or the U.S. Department of the Treasury ("Treasury").

Our investment strategy may also be impacted by other factors such as the state of the overall credit markets, which could impact the availability and costs of financing. Reductions in the availability of financing for our investments could significantly impact our business and force us to sell assets that we otherwise would not sell potentially at losses or at amounts below their true fair value.

Investing in mortgage-related securities on a leveraged basis subjects us to liquidity risk and interest rate risk which are discussed in further detail in Item 3, "Quantitative and Qualitative Disclosures About Market Risk" and in the "Liquidity and Capital Resources" section of this Item 2. With respect to interest rate risk, such risk arises from changes in the absolute level of rates (e.g., the level of LIBOR or Treasury securities rates), changes in relationships between rate indices (e.g., LIBOR versus Treasury securities rates), and changes in the relationships between short-term and long-term rates (e.g., the 2-year Treasury securities rate versus the 10-year Treasury securities rate). Interest rate risk also arises from changes in market spreads reflecting the perceived riskiness of assets (e.g., swap rates and mortgage rates relative to the Treasury securities rates). Because we leverage our capital, changes in interest rates can be disproportionately favorable or unfavorable on our results of operations and our book value. We attempt to manage our exposure to changes in interest rates by investing in shorter duration instruments and managing our investment portfolio within risk tolerances set by our Board of Directors. Our current goal is to maintain a portfolio duration target (a measure of interest rate risk) within a range of 0.5 to 1.5 years. Our portfolio duration could drift outside of our target range due to changes in market conditions, interest rates, market spreads, and activity in our investment portfolio. We will use interest rate swaps to help manage our interest rate risk and, where practical, we will attempt to fund our assets with financings that have similar terms as the related investments. In general, mortgage portfolios have interest rate risk and, when financed with repurchase agreements, will underperform in a period of rising interest rates and outperform in a period of declining interest rates.

The interest rates on our assets will generally reset less frequently than the interest rates on our liabilities, particularly our repurchase agreement financing. As such, during periods of rising interest rates, we will generally experience a reduction in our net interest income, notwithstanding our efforts to manage interest rate risk. This reduction in net interest income will be larger when short-term interest rates are rising rapidly. With the maturities of our assets generally of longer term than those of our liabilities, interest rate increases will also tend to decrease the market value of our assets (and therefore our book value).

Many of our investments are purchased at premiums to their par balance. Because we amortize premiums based on contractual payments as well as actual and expected future principal prepayments on the investments, changes in actual and expected prepayment rates will impact our yield on these investments. Principal prepayments on our investments are influenced by changes in market interest rates and a variety of economic, geographic, and other factors beyond our control. In addition, actions taken by the U.S. government could increase prepayments as discussed further below under “Trends and Recent Market Impacts”. Increasing prepayments on premium assets will reduce their overall yield, negatively impacting our results. We attempt to manage the risks of purchasing assets at a premium by purchasing assets with protection from prepayments (e.g., Agency CMBS) and by purchasing assets which we believe will have less susceptibility to prepayments (e.g., hybrid Agency ARMs collateralized by interest-only loans).

Trends and Recent Market Impacts

The following marketplace conditions and prospective trends have impacted and may continue to impact our future results of operations:

Credit Markets and Liquidity Risk

Our business model requires that we have access to leverage, principally the repurchase agreement market. Repurchase agreement financing is uncommitted financing and as such, there can be no guarantee that we will always have access to such financing. During periods of sustained volatility in the credit markets, such as was experienced in 2008, access to repurchase agreement financing may be limited as liquidity providers reduce their exposure to the short term funding credit markets. In an attempt to manage this risk, we seek to diversify our exposure to repurchase agreement counterparties and seek to extend the maturity dates of our repurchase agreements where practicable. We believe the diversification of counterparties reduces, but does not eliminate, our liquidity risk resulting from the exit or failure of one or more of our repurchase agreement counterparties. For additional information regarding liquidity risk, please refer to "Quantitative and Qualitative Disclosures about Market Risk" within Part I, Item 3 of this Quarterly Report on Form 10-Q, as well Item 1A "Risk Factors" contained within the Company's Annual Report on Form 10-K for the year ended December 31, 2010 within the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2011.

MF Global, Inc., a subsidiary of MF Global Holdings, Inc., was one of our counterparties as of September 30, 2011. On October 31, 2011, MF Global Holdings, Inc., filed for bankruptcy protection. MF Global, Inc. was not part of the bankruptcy

filing, but will be liquidated by the Security Investor Protection Corporation ("SIPC") for the benefit of its creditors. The Company did not have any borrowings outstanding with MF Global, Inc. at the time of its parent's bankruptcy filing and therefore has no direct exposure to its liquidation by SIPC.

Short-term Interest Rates

In response to the volatility and lack of liquidity in the credit markets in 2008, the Federal Open Market Committee of the Federal Reserve ("FOMC") lowered the Federal Funds Target Rate (the rate at which U.S. banks may borrow from each other) from 4.25% at the beginning of 2008 to its current targeted rate of 0.25%. While the credit markets are functioning more normally and liquidity has generally returned, economic activity in the U.S. has remained muted, as measured by gross domestic product, low rates of capacity utilization and high rates of unemployment. As a result, the FOMC has pledged to keep the Federal Funds Target Rate at the historically low target range of 0% to 0.25% through mid-2013 given the above concerns and the subdued outlook for inflation over the medium term. As economic activity improves, the Federal Reserve may decide to increase the Federal Funds Target Rate. Such an increase would likely increase our funding costs because, as discussed above, our repurchase agreement financing is based on LIBOR, which typically closely tracks the Federal Funds Target Rate.

Yield Curve

As of September 30, 2011, the spread between the two-year Treasury security and the ten-year Treasury security was 1.67% versus 2.70% as of June 30, 2011, 2.65% as of March 31, 2011 and 2.70% as of December 31, 2010, respectively. During the third quarter, the yields on the two-year Treasury declined 0.21% while the yield on the ten-year Treasury declined by 1.24%, resulting in a flattening of the yield curve. While our borrowing costs are based on short-term market rates such as LIBOR and the Federal Funds Target Rate, our asset yields more closely correlate with longer-term Treasury rates and longer-term swap rates. As discussed previously, we hedge our exposure to changes in interest rates principally by entering into pay-fixed interest rate swaps. A flattening of the yield curve will generally result in a reduction in value of our interest rate swaps and an increase in value of our MBS. The relationship is not one-to-one, however, and in the third quarter of 2011 our interest rate swaps declined in value by amounts in excess of the increase in our MBS, due primarily to the widening of credit spreads in our MBS investments. This resulted in a decline in our book value from a reduction in accumulated comprehensive income and also resulted in margin calls on our interest rate swaps.

A flattening of the yield curve generally will also result in reduced net interest spread on new investments that we may purchase from reinvestment of prepayments or if we raise additional capital. Despite the flattening of the yield curve, we continue to see attractive investment opportunities to purchase MBS at acceptable yields relative to the cost of financing such investments.

Prepayments and Agency MBS

We have continued to experience favorable prepayment activity on our Agency RMBS due in large part to the inability of borrowers to refinance their mortgages. Our average constant prepayment rate, or CPR, for our Agency RMBS during the third quarter of 2011 was 23.9% versus 23.4% for the second quarter of 2011, 21.9% for the first quarter of 2011, and 25.8% for all of 2010. As of September 30, 2011, the weighted average coupon on the mortgage loans underlying our Agency RMBS was 5.09%, while the average for the past twelve months of the 30-year fixed mortgage rate and the 5-year hybrid ARM mortgage rate, as published by Freddie Mac, were 4.56% and 3.46%, respectively. Generally, this type of interest rate environment encourages the average borrower to refinance their mortgage loans at lower rates. However, in many cases, obstacles exist to refinancing, including but not limited to, the lack of borrower’s equity in the underlying real estate and the lack of an acceptable level of income. These obstacles are currently contributing to the limited refinancing of loans in our Agency RMBS portfolio and are keeping

prepayment speeds relatively low. During the third quarter of 2011, however, the ten-year treasury rate declined 1.24% to 1.92% as of September 30, 2011. Mortgage rates are based primarily on the current and anticipated level of the ten-year treasury rate and are often adjusted on a trailing basis. Given the decline in rates during the quarter, the proposed changes to the Home Affordable Refinance Program ("HARP"), and the commitment by the Federal Reserve to keep long-term rates low through "Operation Twist" (discussed further below), the Company revised its estimated forecasted prepayment speeds on its Agency RMBS for the next twelve months to 28.0% CPR. While historically our prepayment speeds have been less than this, given the reasons set forth above, we expect prepayment speeds on our Agency RMBS will increase in subsequent quarters. As discussed above, increased prepayments may impact our net interest income by increasing the amortization expense on any investments which we own at premiums to their par balance.

GSE Reform

On February 11, 2011, the Treasury released proposals to limit or potentially wind down the role that Fannie Mae and Freddie Mac play in the mortgage market. Any such proposals, if enacted, may have broad adverse implications for the MBS

market and our business, results of operations, and financial condition. We expect such proposals to be the subject of significant discussion, and it is not yet possible to determine whether such proposals will be enacted. We do not believe the ultimate reform of Fannie Mae and Freddie Mac will occur in 2011.

Financial Regulatory Reform and Other Government Activity

In July 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was enacted into law. This legislation aims to restore responsibility and accountability to the financial system. It is unclear how this legislation may impact the borrowing environment, the investing environment for Agency and non-Agency MBS, or interest rate swaps and other derivatives because much of the Dodd-Frank Act's implementation has not yet been defined by regulators.

In addition to the lowering of the Federal Funds Target Rate discussed above, the Federal Reserve also responded to market instability and economic weakness by purchasing Agency MBS and Treasury securities. From January 2009 through June 2011 the Federal Reserve purchased approximately $1.25 trillion of Agency MBS and $600 billion in Treasury securities of varying maturities. In September 2011, the FOMC announced its intention to sell shorter-term Treasury securities and purchase longer-term Treasury securities in response to weakening economic conditions in a policy operation which has become known as "Operation Twist". The stated intention of the FOMC in Operation Twist is to put downward pressure on longer-term interest rates and to help make broader financial conditions more accommodative. The impact of the Federal Reserve's purchasing activities in the future are unknown.

The U.S. government is providing homeowners with assistance in avoiding residential mortgage loan foreclosures. The programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans, the rate of interest payable on the loans, or to extend the payment terms of the loans. While the effect of these programs has not been as extensive as originally expected, the government may change them or add new programs in the future. The GSEs have proposed changes to HARP that are designed to make it easier for borrowers to refinance residential mortgages, which could increase prepayment rates on mortgage loans underlying our investment securities. The impact of these programs may have the effect of increasing prepayment rates and reducing the principal or interest payments on residential mortgage loans held by certain types of borrowers. The effect of such programs for holders of Agency RMBS could be that such holders would experience changes in the anticipated yields of their Agency RMBS due to increased prepayment rates and lower interest and principal payments.

Highlights of the Third Quarter and Fourth Quarter Outlook

During the third quarter of 2011, we reported net income of $1.5 million, or $0.04 per common share, and net interest income of $14.6 million. Our results for the third quarter of 2011 were impacted by several items, including a litigation settlement and related defense costs of $8.2 million, a non-cash charge of $2.0 million on the redemption of non-recourse collateralized financings, and a net $1.3 million increase in accelerated investment premium amortization from an increase in forecasted prepayment rates on our Agency RMBS. Each of these items is discussed further below in "Results of Operations".

In addition, our shareholders' equity declined to $369.5 million as of September 30, 2011, or $9.15 per common share, from $386.9 million, or $9.59 per common share as of June 30, 2011. Of the $0.44 decline in book value per common share, $0,21 related to decline in fair value of our investment portfolio (which was recorded as a reduction in accumulated other comprehensive income) with the balance of the decline primarily from the items noted in the paragraph above.

Our net interest income for the third quarter of 2011 benefited from strong investment portfolio growth and a stable net interest spread offset in part by increased premium amortization expense on our investments. Our net interest

spread on our investment portfolio declined modestly for the third quarter of 2011 to 2.43% from 2.45% for the second quarter of 2011. The net interest spread for the third quarter of 2010 was 2.98%. For a discussion of our net interest income and net interest spread by investment type for the three and nine months ended September 30, 2011, see “Results of Operations”.

We continue to believe that the outlook for our business model is favorable given the economic backdrop, despite the uncertainty regarding government policy and its potential affects on prepayments of our investments, and the uncertainty in Europe and its potential impact on the U.S. credit markets. In recent quarters we have expanded our investment portfolio to include Agency CMBS interest-only securities and non-Agency CMBS given the attractive risk-adjusted return and prepayment protection profile of these investments. Our investment portfolio has been constructed in a manner that we believe will offset trends to faster prepayment speeds. Explicitly, prepayment protected securities equate to 51% of our portfolio on a dollar premium basis, with another 8% in Agency ARMs with less than 15 months-to-reset and which have a favorable prepayment profile.

We expect to continue to invest more heavily in non-Agency MBS over the balance of the year to return to our targeted investment portfolio mix. As stated earlier, our investment in Agency MBS is approximately 80% of our investment portfolio

which is outside of our targeted range of 50%-70%. We continue to invest to construct a portfolio that minimizes prepayment risk, credit risk, and extension risk.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. We base these estimates and judgments on historical experience and assumptions believed to be reasonable under current facts and circumstances. Actual results, however, may differ from the estimated amounts we have recorded.

Our accounting policies that require the most significant management estimates, judgments, or assumptions and considered most critical to our results of operations or financial position relate to consolidation of subsidiaries, impairments, allowance for loan losses, derivatives, fair value measurements, and amortization of premiums/discounts on Agency MBS. Our critical accounting policies are discussed in our Annual Report on Form 10-K for the year ended December 31, 2010 under “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies” and in Note 1 of the Notes to Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. There have been no changes in our critical accounting policies discussed in our Annual Report on Form 10-K for the year ended December 31, 2010, except as discussed in Note 1 contained within Item 1 of Part I to this Quarterly Report on Form 10-Q.

FINANCIAL CONDITION

The following discussion addresses our balance sheet items that had significant activity during the past nine months and should be read in conjunction with the Notes to Unaudited Consolidated Financial Statements contained within Item 1 of Part I to this Quarterly Report on Form 10-Q.

Agency MBS

Activity related to our Agency MBS, which are classified as available-for-sale and carried at fair value, for the nine months ended September 30, 2011 is as follows:

	September 30, 2011		
(amounts in thousands)	RMBS	CMBS	Total
Beginning balance	$986,011	$206,568	$1,192,579
Purchases	1,189,862	143,747	1,333,609
Principal payments	(325,893)	(3,289)	(329,182)
Sales	(117,665)	(2,044)	(119,709)
Net unrealized (loss) gain	(393)	14,511	14,118
Net amortization	(15,701)	(3,604)	(19,305)
Ending balance	$1,716,221	$355,889	$2,072,110

The following table presents the fair value of our Agency MBS portfolio as of September 30, 2011 and December 31, 2010 by government issuer and type of security:

	September 30, 2011			December 31, 2010		
(amounts in thousands)	Fannie Mae	Freddie Mac	Total	Fannie Mae	Freddie Mac	Total
Hybrid ARMs	$897,728	$439,547	$1,337,275	$496,601	$262,878	$759,479
ARMs	208,495	150,282	358,777	198,638	27,821	226,459
Interest only	3,397	47,336	50,733	—	—	—
Fixed rate	305,156	20,169	325,325	206,641		206,641
	$1,414,776	$657,334	$2,072,110	$901,880	$290,699	$1,192,579

The following table presents the weighted average coupon ("WAC") based on the par value of our Agency MBS portfolio as of September 30, 2011 and December 31, 2010 by weighted average months-to-reset ("MTR"):

	September 30, 2011			December 31, 2010		
MTR	Par Value (1)	WAC (1) (2)		Par Value	WAC(3)	
(amounts in thousands)						
0-12 months	$339,861	7.34	%	$216,420	3.35	%
13-24 months	420,960	5.13	%	189,841	5.50	%
25-36 months	167,342	4.72	%	304,713	5.10	%
Over 36 months	671,403	4.41	%	226,329	3.81	%
Fixed rate	290,712	4.96	%	190,584	5.41	%
	$1,890,278	5.21	%	$1,127,887	4.62	%

(1) The par value and WAC presented exclude our interest only investments which have a combined notional balance of $1.5 billion, amortized cost of $51.7 million, and a WAC of 0.76% as of September 30, 2011.

(2) As of September 30, 2011, approximately 3% of our Agency ARMs and hybrid ARMs reset based upon the level of six month LIBOR, 88% reset based on the level of one-year LIBOR and 9% reset based on the level of one-year CMT.

(3) As of December 31, 2010, approximately 5% of our Agency ARMs and hybrid ARMs reset based upon the level of six month LIBOR, 92% reset based on the level of one-year LIBOR and 3% reset based on the level of one-year CMT.

Please also refer to "Net Interest Income – Agency MBS" contained within "Results of Operations" of this Item 2 as well as Note 3 of the "Notes to the Consolidated Financial Statements" contained within Item 1 of Part I of this Quarterly Report on Form 10-Q for additional information relating to our Agency MBS.

Non-Agency MBS

Activity related to our non-Agency MBS, which are classified as available-for-sale and carried at fair value, for the nine months ended September 30, 2011 is as follows:

	September 30, 2011					
(amounts in thousands)	RMBS		CMBS		Total	
Beginning balance	$15,408		$251,948		$267,356	
Purchases	3,000		154,413		157,413	
Principal payments	(1,225	)	(14,046	)	(15,271	)
Sales	(3,765	)	—		(3,765	)
Net unrealized (loss) gain	(592	)	265		(327	)
Net accretion (amortization)	95		(1,796	)	(1,701	)
Ending balance	$12,921		$390,784		$403,705	

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The following table presents our non-Agency MBS portfolio grouped by investment rating as of September 30, 2011:

(amounts in thousands)	RMBS	CMBS	Total
AAA	$4,074	$212,654	$216,728
AA	206	77,984	78,190
A	72	85,126	85,198
Below A/Not Rated	8,569	15,020	23,589
	$12,921	$390,784	$403,705

The following table presents the geographic diversification of the collateral underlying our non-Agency CMBS by the top 5 states as of September 30, 2011:

(amounts in thousands)	Market Value of Collateral	Percentage	
Florida	$56,814	14.4	%
Texas	48,029	12.2	%
California	43,566	11.0	%
North Carolina	26,667	6.7	%
Virginia	22,743	5.8	%
Remaining states (not exceeding 5.7% individually)	197,319	49.9	%
	$395,138	100.0	%

Please also refer to “Net Interest Income – Non-Agency MBS” contained within “Results of Operations” of this Item 2 as well as Note 4 of the “Notes to the Consolidated Financial Statements” contained within Item 1 of Part I of this Quarterly Report on Form 10-Q for additional information relating to our non-Agency MBS.

Derivative Assets and Liabilities

Our volume of derivative instruments, which currently consist entirely of interest rate swap agreements, has increased significantly since December 31, 2010. The notional amount outstanding for our interest rate swap agreements as of September 30, 2011 is $1,022.0 million with a weighted average fixed rate swapped of 1.58% compared to a notional amount outstanding of $345.0 million with a weighted average fixed rate swapped of 1.67% as of December 31, 2010. We use interest rate swaps primarily to hedge our exposure to increases in interest rates resulting from the repurchase agreements we use to fund our investment purchases. As such, we have increased our volume of interest rate swap activity to compensate for the growth in our repurchase agreement borrowings used to fund our investment portfolio.

Since December 31, 2010, we have entered into and designated three of our interest rate swaps as trading instruments. These derivatives are carried on our consolidated balance sheet as a liability with a fair value of $2.3 million as of September 30, 2011. The changes in fair value for these instruments is recognized immediately in the current period's statement of income within "fair value adjustments, net". For the three and nine months ended September 30, 2011, we recognized a loss of $1.1 million and $2.3 million, respectively, related to these trading instruments, but these losses were partially offset by recognized unrealized gains of $0.4 million and $1.5 million, respectively, on the portion of our Agency MBS investments also designated as trading.

Our remaining interest rate swap agreements are designated as cash flow hedging instruments. As of September 30, 2011, our consolidated balance sheet includes derivative liabilities with a fair value of $26.5 million. Changes in their fair value that are the result of the effective portion of the hedge relationship are recorded in other comprehensive income and later reclassified into the statement of income within "interest expense" in the same period during which the hedged transaction affects earnings. For the three and nine months ended September 30, 2011, our interest rate swap expense was $3.4 million and $8.3 million, respectively, compared to $0.7 million and $1.7 million for the three and nine months ended September 30, 2010, respectively, the difference of which is primarily related to the increase

in volume of our derivative instruments. Changes in their fair value related to the ineffective portion of the hedge is immediately reported in the current period’s statement of income within "other income (expense), net". The expenses related to our hedging ineffectiveness that we recorded for the three and nine months ended September 30, 2011 and September 30, 2010 were immaterial.

Repurchase Agreements

Repurchase agreements increased a net $819.5 million from December 31, 2010 to September 30, 2011 primarily due to additional borrowings to finance our purchases of Agency MBS. Please refer to Note 8 of the "Notes to the Consolidated Financial Statements" contained within Item 1 of Part I of the Quarterly Report on Form 10-Q as well as "Liquidity and Capital Resources" contained within this Item 2 for additional information relating to our repurchase agreements.

Payable for Securities Pending Settlement

As of September 30, 2011, we had a payable of $74.1 million which includes $25.5 million and $24.9 million outstanding for pending purchases of Agency MBS and non-Agency MBS, respectively. This payable also includes $23.7 million outstanding for the redemption of a portion of our non-recourse collateralized financing. These amounts will be paid in the fourth quarter of 2011 using a combination of cash and repurchase agreement financing.

Shareholders' Equity

Shareholders' equity increased during the nine months ended September 30, 2011 primarily because of our issuance of 9.7 million shares of our common stock, which resulted in proceeds of $95.3 million, net of issuance costs. Additional increases in shareholders' equity resulted from net income of $25.4 million, partially offset by dividends declared on our common stock of $32.7 million.

Supplemental Investment Information

The tables below summarize the financial condition and net interest income of our investment portfolio by major category as of the dates presented:

	As of September 30, 2011			
(amounts in thousands)	Asset Carrying Basis	Associated Financing[1]/ Liability Carrying Basis	Allocated Shareholders' Equity	% of Shareholders' Equity
Agency RMBS	$1,716,221	$1,542,593	$173,628	47.0 %
Agency CMBS	355,889	251,341	104,548	28.3 %
Non-Agency RMBS	12,921	10,048	2,873	0.8 %
Non-Agency CMBS	390,784	322,850	67,934	18.4 %
Securitized mortgage loans	118,700	84,965	33,735	9.1 %
Other investments	1,059	—	1,059	0.3 %
Derivative assets (liabilities)	—	28,838	(28,838)	(7.8)%
Cash and cash equivalents	10,156	—	10,156	2.7 %
Other assets/other liabilities	27,956	23,517	4,439	1.2 %
	$2,633,686	$2,264,152	$369,534	100.0 %

(amounts in thousands)	As of December 31, 2010 Asset Carrying Basis	Associated Financing[1]/ Liability Carrying Basis	Allocated Shareholders' Equity	% of Shareholders' Equity
Agency RMBS	$986,011	$869,537	$116,474	39.9 %
Agency CMBS	206,568	150,178	56,390	19.3 %
Non-Agency RMBS	15,408	12,126	3,282	1.1 %
Non-Agency CMBS	251,948	200,328	51,620	17.7 %
Securitized mortgage loans	152,962	109,119	43,843	15.0 %
Other investments	1,229	—	1,229	0.4 %
Derivative assets (liabilities)	692	3,532	(2,840)	(1.0)%
Cash and cash equivalents	18,836	—	18,836	6.4 %
Other assets/other liabilities	15,930	12,407	3,523	1.2 %
	$1,649,584	$1,357,227	$292,357	100.0 %

(1) Associated financing related to investments includes repurchase agreements, securitization financing issued to third parties, and TALF financing (the latter two of which are presented on the Company's balance sheet as "non-recourse collateralized financing"). Associated financing for derivative instruments represents the fair value of the interest rate swap agreements in a liability position.

RESULTS OF OPERATIONS

Three Months Ended September 30, 2011 Compared to Three Months Ended September 30, 2010

Net Interest Income - Agency MBS

The following table provides a summary of the results of our Agency MBS investments and related financings by type of collateral for the periods indicated:

	Three Months Ended September 30,					
	2011			2010		
(amounts in thousands)	Income (Expense) [1]	Average Balance[2]	Effective Yield (Rate)[3]	Income (Expense) [1]	Average Balance[2]	Effective Yield (Rate)[3]
Agency RMBS	$11,804	$1,782,841	2.89 %	$4,890	$505,263	3.35 %
Financing	(2,798)	(1,676,537)	(0.66)%	(851)	(463,559)	(0.58)%
Net interest income/spread	$9,006		2.23 %	$4,039		2.77 %
Agency CMBS	$2,316	$247,298	3.74 %	$717	$69,132	4.11 %
Financing	(1,000)	(173,642)	(2.26)%	(38)	(52,443)	(1.54)%
Net interest income/spread	$1,316		1.48 %	$679		2.57 %
Agency IOs	$778	$37,475	7.01 %	$—	$—	— %
Financing	(87)	(30,711)	(1.11)%	—	—	— %
Net interest income/spread	$691		5.90 %	$—		— %
Total Agency MBS	$14,898	$2,067,614	3.11 %	$5,607	$574,395	3.44 %
Total financing	(3,885)	(1,880,890)	(0.81)%	(889)	(516,002)	(0.69)%
Total net interest income/spread: Agency MBS	$11,013		2.30 %	$4,718		2.75 %

(1) Expense amounts and financing rates include allocated interest rate expense on interest rate swaps designated as hedges.

(2) Average balances are calculated as a simple average of the daily balances and exclude unrealized gains and losses.

(3) Effective yields (rates) are based on annualized income (expense) amounts. Recalculation of effective yields and rates may not be possible using data provided because certain income and expense items of a one-time nature are not annualized for the calculation of effective yields or rates. An example of such a one-time item is the retrospective adjustments of discount and premium amortizations arising from adjustments of effective interest rates.

Our interest income from Agency MBS increased for the three months ended September 30, 2011 compared to the three months ended September 30, 2010 due to our purchases of $1,661.7 million of Agency RMBS and $249.3 million of Agency CMBS subsequent to September 30, 2010.

Offsetting the benefit of these purchases, our interest income and effective yield on Agency MBS were negatively impacted during the three months ended September 30, 2011 by an increase in our net premium amortization, which increased $9.1 million to $9.6 million for the three months ended September 30, 2011 compared to $0.5 million for the three months ended September 30, 2010. This increase in net premium amortization is due primarily to purchases of higher-priced Agency MBS at lower effective yields, and to a lesser extent, an increase in our forecasted prepayment speeds to 28% CPR. As stated in our "Executive Overview", we believe that prepayment speeds on our Agency RMBS investments will increase in the next twelve months as a result of the lower interest rate environment and the proposed changes to the HARP program. Increasing our forecasted prepayment speed reduced our interest income from Agency MBS by increasing our net premium amortization expense for the three months ended September 30, 2011 by an additional $1.3 million.

Excluding interest rate swap expense, our financing cost for Agency MBS increased $0.8 million to $1.2 million for the

three months ended September 30, 2011 from $0.4 million for the three months ended