LUMINENT MORTGAGE CAPITAL INC
Form 424B3
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Registration No. 333-107981

PROSPECTUS SUPPLEMENT

(To Prospectus dated February 13, 2004)

11,500,000 Shares

Common Stock

The selling stockholders named in this prospectus may offer up to 11,500,000 common shares of Luminent Mortgage Capital, Inc. We will not receive any portion of the proceeds from their sale of our shares. Our common stock is subject to transfer restrictions designed to preserve our status as a real estate investment trust. See Description of Capital Stock Transfer Restrictions in the prospectus accompanying this prospectus supplement.

We recently completed our initial public offering of 13,110,000 shares of common stock.

Our common stock is listed on the New York Stock Exchange under the symbol LUM. On February 27, 2004 the last reported sale price of our common stock on the NYSE was $15.02 per share.

Investing in our common stock involves risks. See Risk Factors beginning on page S-10 of this prospectus supplement for a discussion of risks relating to our common stock, including, among others:

We commenced operations in June 2003 and have a limited operating history. Our manager, Seneca Capital Management LLC, or Seneca, has no prior experience managing a REIT. Accordingly, we might not be able to operate our business or implement our operating policies and strategies successfully.

Our investment strategy permits us to invest up to 10% of our assets in unrated mortgage-related assets, including mortgage-backed securities rated below investment grade. These assets carry an increased likelihood of default or rating downgrade relative to investment-grade assets, which may cause us to suffer losses.

Interest rate mismatches between our mortgage-backed securities and our borrowings used to fund our purchases of mortgage-backed securities might reduce our net income or result in a loss during periods of changing interest rates.

Increased levels of prepayments on the mortgages underlying our mortgage-backed securities might decrease our net interest income or result in a net loss.

We generally seek to borrow eight to 12 times the amount of our equity. Such leveraging could reduce our net income and our cash available for distributions or cause us to suffer losses.

Our board of directors may change our operating policies and strategies without prior notice to you or stockholder approval and such changes could harm our business and results of operations and the value of our stock.

Our results may suffer as a consequence of a potential conflict of interest arising out of our relationship with Seneca, on the one hand, and Seneca s relationship with other third parties, on the other hand. In addition, this potential conflict may reduce the amount of time and effort that Seneca devotes to managing our business and may result in suitable investment opportunities being allocated to other entities.

We pay Seneca incentive compensation based on our portfolio s performance. Accordingly, Seneca may recommend riskier or more speculative investments in an effort to maximize its incentive compensation.

The selling stockholders are offering these shares of common stock. The selling stockholders may sell all or a portion of these shares from time to time in market transactions through the NYSE or any other stock exchange or market on which our common stock is listed, in negotiated transactions or otherwise, and at prices and on terms that will be determined by the then prevailing market price or at negotiated prices directly or through a broker or brokers, who may act as agent or as principal or by a combination of such methods of sale. The selling stockholders will receive all proceeds from the sale of the shares of our common stock. For additional information on the methods of sale, you should refer to the section entitled Plan of Distribution on page 107 of the prospectus accompanying this prospectus supplement.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is March 3, 2004

This document is in two parts. The first part is this prospectus supplement, which adds to and updates information contained in the accompanying prospectus. The second part is the accompanying prospectus, which describes this offering and gives more general information about the shares of common stock being offered by our selling stockholders. To the extent there is a conflict between the information contained in this prospectus supplement, on the one hand, and the information contained in the accompanying prospectus, on the other hand, the information in this prospectus supplement shall control.

You should rely only on the information contained in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with information that is different. This prospectus supplement and the accompanying prospectus may be used only where it is legal to sell these securities. The information in this prospectus supplement and the accompanying prospectus may be accurate only on the date of this prospectus supplement.

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We have filed for registration in the U.S. Patent and Trademark Office for the marks Luminent Mortgage Capital, Inc. and Luminent. All other brand names or trademarks appearing in this prospectus are the property of their respective holders.

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PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights the material information contained elsewhere in this prospectus supplement and the accompanying prospectus. You should read this entire prospectus supplement and the accompanying prospectus carefully, including the section titled Risk Factors and our financial statements and the notes thereto before making an investment in our common stock. As used in this prospectus, Luminent, company, we, our, and us refer to Luminent Mortgage Capital, Inc., except where the context otherwise requires.

Luminent Mortgage Capital, Inc.

We were incorporated in April 2003 to invest primarily in U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities, which we acquire in the secondary market. Our strategy is to acquire mortgage-related assets, finance these purchases in the capital markets and use leverage in order to provide an attractive return on stockholders equity. Through this strategy, we seek to earn income, which is generated from the spread between the yield on our earning assets and our costs, including the interest cost of the funds we borrow.

We commenced operations in June 2003, following the completion of a private placement of our common stock, in which we raised net proceeds of approximately $159.7 million. On December 18, 2003, we completed the initial public offering of our shares of common stock and began trading on the New York Stock Exchange, or NYSE, under the trading symbol LUM on December 19, 2003. The initial public offering raised approximately $170.4 million in gross proceeds. We received the net proceeds from our initial public offering in late December. As of December 31, 2003, we had invested substantially all of the net proceeds from that offering, plus approximately $1.7 billion of borrowed funds, in a total of $2.2 billion of U.S. agency and other highly-rated, residential mortgage-backed securities. However, at December 31, 2003, we had not fully levered our portfolio to within our target range of eight to 12 times the amount of our equity. As a result, the total amount of mortgage-backed securities and repurchase agreement liabilities as of December 31, 2003 were lower than they will be once our portfolio is fully levered through additional repurchase agreement liabilities and related mortgage-backed security purchases. We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. Adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis. Hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter reset periodically in a manner similar to adjustable-rate mortgage-backed securities. As of December 31, 2003, approximately 8.6% of our investment portfolio was comprised of adjustable-rate mortgage-backed securities and approximately 88.9% was comprised of hybrid adjustable-rate mortgage-backed securities. In addition, as of December 31, 2003, 63% of the mortgage-backed securities in our investment portfolio were guaranteed by Fannie Mae, Freddie Mac or the Government National Mortgage Administration, or Ginnie Mae, and the remaining 37% had AAA credit ratings from at least one nationally-recognized statistical rating agency.

We have acquired and will seek to acquire additional assets that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments. All of the mortgage-backed securities that we acquired with the net proceeds of our recent initial public offering, or IPO, are agency-backed or have AAA credit ratings from at least one nationally-recognized statistical rating agency, and most of the securities are hybrid adjustable-rate mortgage-backed securities. As of June 30, 2003, the market for residential mortgage debt that had been securitized into mortgage-backed securities was approximately $4.0 trillion, approximately $3.2 trillion of which was agency-backed and, therefore, generally consistent with our investment guidelines. As of June 30, 2003, approximately $45.0 billion of the available mortgage-backed securities was held by REITs. As of September 30, 2003, the market for residential mortgage debt that had been securitized into mortgage-backed securities was approximately $4.1 trillion, approximately $3.3 trillion of which was agency-backed and, therefore, generally consistent with our investment guidelines. As of September 30, 2003, approximately $47.2 billion of the available mortgage-backed securities was held by REITs.

We have financed our acquisition of mortgage-related assets by investing our equity and by borrowing at short-term rates under repurchase agreements. We intend to continue to finance our acquisitions in this manner. We generally seek to borrow between eight and 12 times the amount of our equity. We actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the adjustment periods and the selection of indices on our mortgage-related assets in order to manage our liquidity and interest rate related risks. We may also choose to engage in various hedging activities designed to match more closely the terms of our assets and liabilities. As of December 31, 2003, we had entered into hedging arrangements as described in Recent Developments below.

As a long-term holder of mortgage-backed securities we are focused on acquiring, financing and managing a diverse portfolio of mortgage-backed securities with a variety of characteristics that we believe will provide attractive returns in a multitude of interest rate and prepayment environments. We do not construct our overall investment portfolio in order to express a directional expectation for interest rates or mortgage prepayment rates.

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We review the credit risk associated with each potential investment and may diversify our portfolio to avoid undue geographic, insurer, industry and other types of concentrations. By maintaining a large percentage of our assets in high quality and highly-rated assets, many of which are guaranteed under limited circumstances as to payment of a limited amount of principal and interest by federal agencies or federally chartered entities such as Fannie Mae, Freddie Mac or Ginnie Mae, we believe we can mitigate our exposure to losses from credit risk.

In addition to the strategies described above, we intend to use other strategies to seek to generate earnings and distributions to our stockholders, which may include the following:

- increasing the size of our balance sheet at a rate faster than the rate of increase in our operating expenses;
- using leverage to increase the size of our balance sheet; and
- lowering our effective borrowing costs over time by seeking direct funding with collateralized lenders.

We are externally managed and advised by Seneca Capital Management LLC, or Seneca, pursuant to a management agreement with Seneca. We have a full-time chief financial officer, who is not employed by Seneca, to provide us with dedicated financial management, analysis and investor relations capability.

We expect to qualify and will elect to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, and as such will routinely distribute substantially all of the income generated from our operations to our stockholders. As long as we retain our REIT status, we generally will not be subject to U.S. federal or state taxes on our income to the extent that we distribute our net income to our stockholders.

Our principal offices are located at 909 Montgomery Street, Suite 500, San Francisco, California 94133. Our telephone number is (415) 486-2110.

Recent Developments

Following the completion of our private placement in June and the purchase of substantially all of our mortgage-backed securities with the net proceeds of our private placement, the U.S. bond markets experienced dramatic price and yield volatility. For example, between June 1, 2003 and September 30, 2003, the 10-year U.S. Treasury yield ranged from a low of 3.11% on June 13, 2003 to a high of 4.60% on September 2, 2003, an increase of approximately 48%. This increase in interest rates caused the overall market value of our portfolio to decrease, and our leverage (defined as our total debt divided by stockholders equity) to increase beyond our desired range. By August 13, 2003, the 10-year U.S. Treasury yield had increased to 4.56% and, as a result, the unrealized loss on the securities in our portfolio had increased to $37.8 million and our leverage correspondingly increased to 13.6 times our stockholders equity.

In response to these conditions, we implemented a strategy of reducing portfolio leverage by selling approximately $130.7 million of our mortgage-backed securities on August 13, 2003. On August 14, 2003, we also sold short approximately $200.0 million of Fannie Mae 15-year 4.50% coupon mortgage-backed securities for settlement on September 18, 2003 in an effort to seek to protect the value of our portfolio against possible additional increases in interest rates. This short position was fully covered between September 11, 2003 and September 15, 2003. These strategies successfully reduced our leverage and overall risk exposure to further increases in interest rates. Although these activities resulted in losses, other means of generating cash to reduce leverage were not practically available to us at that time. For example, because we had purchased our portfolio so recently, cash flow from interest income and prepayments was insufficient to enable us to reduce leverage through the ordinary course of portfolio management. Similarly, because our registration statements were pending with the Securities and Exchange Commission, or the SEC, additional capital could not be readily raised during this time period to effect a reduction in leverage. Given the greater seasoning of our portfolio today, the cash flow characteristics of our investments, and an opportunity to raise additional equity as a public company upon completion of our initial public offering, among a number of other considerations, we now have a greater combination of risk mitigation factors that enable us to protect our balance sheet in the future.

During the quarter ended September 30, 2003, we earned net interest income of approximately $6.5 million. However, we realized net capital losses of $7.8 million that resulted in a reported net loss for the quarter of $2.8 million, or $0.24 per fully diluted share. These results are calculated in accordance with accounting principles generally accepted in the United States, which are known as GAAP. When the net capital losses and other compensation and organizational expenses are added back for purposes of calculating the REIT taxable net income for the quarter ended September 30, 2003, REIT taxable net income was approximately $5.7 million or $0.48 per share. REIT taxable net income is calculated according to the requirements of the Internal Revenue Code, rather than GAAP. A reconciliation of our REIT taxable net income to our GAAP-basis net loss as of September 30, 2003 appears on page 51 of the prospectus accompanying this prospectus supplement.

On October 1, 2003, we declared and, on November 17, 2003, we paid a cash distribution of $0.50 per share, which represented 98% of our REIT taxable net income since inception. The cash distribution was funded entirely with cash flow from our

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ongoing operations, including principal payments and interest payments on our mortgage-backed securities. At the end of the quarter, our manager voluntarily waived on a one-time basis its right to receive incentive fees of $613,247 which it otherwise earned during the quarter ended September 30, 2003. The waived incentive fee has been accounted for as a capital contribution as of September 30, 2003. The incentive fee is calculated primarily based upon REIT taxable net income and was expensed in the quarter ended September 30, 2003.

For the month ended September 30, 2003, the yield on average earning assets, net of amortization of premium was 2.61% and the cost of funds on the average repurchase balance as of September 30, 2003 was 1.20%, resulting in an interest rate spread of 1.41%.

Through September 30, 2003, our borrowings have been exclusively in the form of repurchase agreements from a broadly diversified group of repurchase lenders. As of September 30, 2003, the outstanding balance under our repurchase agreements was approximately $1.5 billion, equating to leverage of approximately 10.6, with a weighted average interest rate of 1.20% and a weighted average maturity of 254 days.

As of September 30, 2003, approximately 67% of our assets were invested in agency mortgage-backed securities and the remaining 33% were invested in AAA rated mortgage-backed securities. These mortgage-backed securities were valued at approximately $1.6 billion and were allocated as follows:

12.3% in adjustable-rate mortgage-backed securities;

84.3% in hybrid adjustable-rate mortgage-backed securities, with the majority of our holdings in 3/1 hybrids;

3.4% in one balloon mortgage-backed security which matures in January 2008; and

0.0% in fixed rate mortgage-backed securities.

The constant prepayment rate, or CPR, on our mortgage-backed securities for the month ended September 30, 2003 was 28%. CPR attempts to predict the percentage of principal that will prepay over the next 12 months based on historical principal paydowns. As interest rates have risen, the rate of refinancings has declined sharply, which we believe will result in lower rates of prepayments and, as a result, a lower portfolio CPR.

As of September 30, 2003, the weighted average effective duration of the securities in our overall investment portfolio, assuming constant prepayment rates to the balloon or reset date, or the CPB duration, was 1.7 years. CPB is similar to CPR except that it also assumes that the hybrid adjustable-rate mortgage-backed securities prepay in full at their next reset date. As of September 30, 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had fixed interest rates for a weighted average of 49 months, after which time the interest rates reset and become adjustable. The average length of time until maturity of those mortgages was 30 years. Those mortgages are also subject to interest rate caps that limit the amount that the applicable interest rate can increase during any year, known as an annual cap, and through the maturity of the applicable security, known as a lifetime cap. As of September 30, 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had average annual caps of 2.44% and average lifetime caps of 9.99%.

Average stockholders equity for the quarter ended September 30, 2003 was $147.3 million. Due to the losses on sales of securities described above, return on average equity was (1.89%) for the quarter ended September 30, 2003.

Our book value at September 30, 2003 was $139.5 million, or $11.91 per share, based on 11,704,000 shares outstanding on that date. As of September 30, 2003, the accumulated other comprehensive loss related to the fair market value adjustment for our mortgage-backed securities was $18.2 million, which represents a $13.6 million increase during the quarter.

In the month ended October 31, 2003, we earned net interest income of $2.2 million, and net income of $1.9 million, or $0.16 per fully diluted share. For the month ended October 31, 2003, the yield on average earning assets, net of amortization of premium, was 2.84%, and the cost of funds on our average repurchase agreement liabilities at October 31, 2003 was 1.20%, resulting in an average interest rate spread of 1.64%. The constant prepayment rate, or CPR, on our mortgage-backed securities for the month ended October 31, 2003, was 25%.

Our book value at November 26, 2003 was $126.8 million, or $10.84 per share, based on 11,704,000 shares outstanding on that date. As of November 26, 2003, the accumulated other comprehensive loss related to the fair market value adjustment for our mortgage-backed securities was $21.7 million.

On November 24, 2003 our board of directors declared a cash distribution of $0.45 per share for the fourth quarter of 2003, which we paid on January 28, 2004 to stockholders of record on December 11, 2003. The aggregate amount of our fourth quarter distribution paid on January 28, 2004 was $5.3 million.

For the quarter ended December 31, 2003, we reported net income of $5.4 million or $0.40 diluted earnings per share based on 13,414,260 weighted-average shares outstanding. For the period from April 26, 2003 through December 31, 2003, our net income was $2.8 million, or $0.27 diluted earnings per share, based on 10,139,811 weighted-average shares outstanding.

For the quarter ended December 31, 2003, the weighted-average yield on average earning assets, net of amortization of premium was 2.81% and the weighted average interest rate on our repurchase agreement liabilities was 1.20% resulting in a net interest margin of 1.61%.

At December 31, 2003 our book value was $282.5 million, or $11.38 per share, based on 24,814,000 shares outstanding on that date. As of December 31, 2003, the accumulated other comprehensive loss related to the fair market value adjustment for our mortgage-backed securities was $26.3 million. Our book value at December 31, 2003 includes the impact of the cash distribution of $0.45 per share for the fourth quarter. At December 31, 2003, our outstanding repurchase agreement balance was $1.7 billion, equating to leverage of 6.1, with a weighted-average interest rate of 1.19%. At December 31, 2003, the outstanding repurchase agreements had a weighted-average maturity of 145 days. After consideration of the duration on our Eurodollar futures contracts, the weighted-average maturity of our total liabilities was 255 days.

At December 31, 2003, the weighted-average coupon of our mortgage assets was 4.09%. The constant prepayment rate, or CPR, on our mortgage-backed securities was 23% for the quarter ended December 31, 2003. CPR declined over the course of the fourth quarter. CPR is a measure of the rate of prepayment for our mortgage-backed securities, expressed as an annual rate relative to the outstanding principal balance of our mortgage-backed securities.

As of December 31, 2003, the CPB duration was 1.75 years. As of December 31, 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had fixed interest rates for a weighted-average of approximately 43 months, after which time the interest rates reset and become adjustable. The average length of time until maturity of those mortgages was 30 years. Those mortgages are also subject to interest rate caps that limit the amount that the applicable interest rate can increase during any year, known as an annual cap, and through the maturity of the applicable security, known as a lifetime cap. As of December 31, 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had average annual caps of 2.47% and average lifetime caps of 10.03%.

Average stockholders equity for the period from June 11, 2003, commencement of operations, through December 31, 2003 was $128.8 million. Return on average equity was 3.85% for the period from June 11, 2003, commencement of operations, through December 31, 2003.

At December 31, 2003, approximately 63.2% of our assets were invested in agency securities with the remaining 36.8% invested in AAA-rated, securitized, residential whole loan mortgages. Mortgage assets held at December 31, 2003 were approximately $2.2 billion and were allocated as follows:

8.6% in adjustable-rate mortgage-backed securities;

88.9% in hybrid adjustable-rate mortgage-backed securities;

2.5% in one balloon mortgage-backed security which matures in January 2008; and

0.0% in fixed rate mortgage-backed securities.

As of December 31, 2003, all of the mortgage-backed securities in our portfolio had been purchased at a premium and the portfolio had an average amortized cost of 102.2.

Subsequent to September 30, 2003, we engaged in short sales of Eurodollar futures contracts in order to hedge the impact of changes in interest rates on our liability costs. Between November 21, 2003 and December 31, 2003, we sold short 2,090 Euro dollar futures contracts, which expire in March 2004, June 2004 and September 2004, with a notional amount totaling $2.1 million. The value of these futures contracts is marked to market daily in our margin account with the custodian. Based upon the daily market value of these futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts. The unrealized loss on the Eurodollar futures contracts was $157 thousand at December 31, 2003.

These contracts have been designated as cash flow hedges of our borrowings under repurchase agreements under Statement of Financial Accounting Standards, or SFAS, No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, and therefore we have applied hedge accounting to these transactions. The futures contracts are valued at fair value with the resulting gain or loss associated with the effective portion of the hedge recognized in accumulated other comprehensive income until the quarter following contract expiration. The gain or loss associated with the ineffective portion will be recognized in earnings in the current quarter when the effectiveness measurement is made.

Under SFAS No. 133 and our hedging policy, at the inception and during the life of a hedging relationship, the hedge must be expected to be highly effective in offsetting changes in the hedged item s fair value or the variability in cash flows attributable to the hedged risk. In applying our policy, we have determined that these contracts are highly effective as follows. We use regression methodology to assess the effectiveness of our hedging strategies. Specifically, at the inception of each new hedge, we assess effectiveness using ordinary least squares regression to evaluate the correlation between the rates consistent with the hedges and the underlying hedged items. A hedge is highly effective if the changes in the fair value of the derivative provide offset of at least 80% and not more than 120% of the changes in fair value or cash flows of the hedged item attributable to the risk being hedged.

Risk Factors

An investment in our common stock involves material risks, including a number of potential conflicts of interests between us, on the one hand, and Seneca and its affiliates, on the other hand. Each prospective purchaser of our common stock should consider carefully the matters discussed under Risk Factors beginning on page S-10 of this prospectus supplement before investing in our common stock. Some of the risks include:

We commenced operations in June 2003 and have a limited operating history. Our manager, Seneca, has no prior experience managing a REIT. Accordingly, we might not be able to operate our business or implement our operating policies and strategies successfully.

Our investment strategy permits us to invest up to 10% of our assets in unrated mortgage-related assets, including mortgage-backed securities rated below investment grade. These assets carry an increased likelihood of default or rating downgrade relative to investment-grade assets, which may cause us to suffer losses.

Interest rate mismatches between our mortgage-backed securities and our borrowings used to fund our purchases of mortgage-backed securities might reduce our net income or result in a loss during periods of changing interest rates.

Increased levels of prepayments on the mortgages underlying our mortgage-backed securities might decrease our net interest income or result in a net loss.

We generally seek to borrow eight to 12 times the amount of our equity. Such leveraging could reduce our net income and our cash available for distributions or cause us to suffer losses.

Our board of directors may change our operating policies and strategies without prior notice to you or stockholder approval and such changes could harm our business and results of operations and the value of our stock.

Our results may suffer as a consequence of a potential conflict of interest arising out of our relationship with our manager, on the one hand, and our manager s relationship with other third parties, on the other hand. In addition, this potential conflict may reduce the amount of time and effort that our manager devotes to managing our business and may result in suitable investment opportunities being allocated to other entities.

We pay our manager incentive compensation based on our portfolio s performance. Accordingly, our manager may recommend riskier or more speculative investments in an effort to maximize its incentive compensation.

Our Manager and Executive Officers

Our day-to-day operations are externally managed and advised by our manager, Seneca Capital Management LLC, or Seneca, subject to the direction and oversight of our board of directors. Established in 1989, Seneca is a registered investment adviser under the Investment Advisers Act of 1940, as amended. Seneca engages in investment management as its sole business and manages fixed-income and equity assets for pension and profit-sharing plans, financial institutions, such as banking and insurance companies, and mutual funds for retail and institutional investors. Seneca had over 100 full-time employees and approximately $13 billion of institutional and private investment accounts at September 30, 2003.

From time to time, we will assess whether we should be internally managed. Our assessment will be based on a number of factors deemed relevant by our board of directors, including our ability to attract and retain full-time employees and the costs and expenses related to becoming internally managed.

A majority of the outstanding equity interests of Seneca are owned by Phoenix Investment Partners, Ltd. Phoenix Investment is a wholly-owned subsidiary of The Phoenix Companies, Inc. (NYSE: PNX). Our board of directors consists of seven members, five of whom are not affiliated with Seneca or Phoenix. Neither this prospectus nor this offering are endorsed or guaranteed in any way by Seneca or Phoenix.

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Our executive officers have significant experience in providing investment advisory services, with an average of 16 years of experience. Prior to founding Seneca, Gail Seneca, our chief executive officer, spent two years as senior vice president of the Asset Management Division of Wells Fargo Bank, where she managed fixed-income assets in excess of $10 billion. Before joining Seneca as its fixed income chief investment officer, Albert Gutierrez, our president, spent two years as head of portfolio management, trading and investment systems at American General Investment Management where he was responsible for approximately $75 billion in client assets, and 12 years with Conseco Capital Management as a senior vice president in charge of fixed income research and trading as well as insurance asset portfolio management. Other than our full-time chief financial officer, all of our executive officers are also managers or employees of Seneca, as described in the following table:

Name	Position with Seneca	Position with Us
Gail P. Seneca, Ph.D.	President/Chief Executive Officer and Chief Investment Officer	Chairman of the Board of Directors and Chief Executive Officer
Albert J. Gutierrez, CFA	Fixed Income Chief Investment Officer and Principal	President and Director
Christopher J. Zyda	None	Senior Vice President and Chief Financial Officer
Andrew S. Chow, CFA	Fixed Income Portfolio Manager	Senior Vice President
Troy A. Grande, CFA	Fixed Income Portfolio Manager	Senior Vice President

The Management Agreement

We have entered into a management agreement with Seneca dated June 11, 2003. Pursuant to the management agreement, Seneca, as our sole manager, generally implements our business strategy, is responsible for our day-to-day operations and performs services and activities relating to our assets and operations in accordance with the terms of the management agreement. Seneca s services for us can be divided into the following three primary activities:

Asset Management Seneca advises us with respect to, arranges for and manages the acquisition, financing, management and disposition of, our investments.

Liability Management Seneca evaluates the credit risk and prepayment risk of our investments and arranges borrowing and hedging strategies.

Capital Management Seneca coordinates our capital raising activities.

In conducting these activities, Seneca advises us on the formulation of, and implements, our operating strategies and policies, arranges for our acquisition of assets, monitors the performance of our assets, arranges for various types of financing and hedging strategies, and provides administrative and managerial services in connection with our operations. At all times in the performance of these activities, Seneca is subject to the direction and oversight of our board of directors.

Pursuant to the management agreement and a cost-sharing agreement between Seneca and us, Seneca may earn or be entitled to receive the following compensation, fees and other benefits:

Base management fee 1% per annum of the first $300 million of our average net worth, plus 0.8% per annum of our average net worth in excess of $300 million during such fiscal year, calculated on a quarterly basis;

Incentive compensation a specified percentage of our REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) in excess of a threshold amount of taxable income, calculated on a quarterly basis and subject to annual reconciliation;

Out-of-pocket expense reimbursements reimbursement of actual out-of-pocket expenses incurred in connection with our administration on an on-going basis;

Reimbursement of overhead expenses reimbursement of actual costs attributable to our use of services rendered by Seneca pursuant to the cost-sharing agreement. Our portion of such costs is allocated to us as determined by Seneca, subject to reasonable approval by a majority of our independent directors; and

Termination fee payable only upon termination by us without cause or by Seneca upon our change of control. Actual amount of fee depends on the circumstances of the termination.

For a more detailed discussion of the compensation and other fees payable to Seneca, see the sections titled The Manager The Management Agreement and The Manager The Cost-Sharing Agreement which are included in the prospectus accompanying this prospectus supplement.

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Conflicts of Interest

We are subject to potential conflicts of interest involving Seneca and its affiliates because, among other reasons:

- the incentive compensation, which is based on our net income, may create an incentive for Seneca to recommend investments with greater income potential, which may be relatively more risky than would be the case if its compensation from us did not include an incentive-based component;

- Seneca and its affiliates are permitted to purchase mortgage-backed securities for their own account and to advise accounts of other clients, and certain investment opportunities appropriate for us also will be appropriate for these accounts; and

- two of our directors, and all but one of our executive officers, are managers or employees of, or otherwise affiliated with, Seneca.

For a more detailed discussion of potential conflicts of interests between us, on the one hand, and Seneca and its affiliates, on the other hand, see the section titled Conflicts of Interests; Certain Relationships and Related Transactions which is included in the prospectus accompanying this prospectus supplement.

The management agreement does not limit or restrict the right of Seneca or any of its affiliates from engaging in any business or rendering services to any other person, including, without limitation, the purchase of, or rendering advice to others purchasing, mortgage-backed securities that meet our investment guidelines. However, Seneca has agreed that for as long as Seneca is our exclusive manager pursuant to the management agreement, it will not sponsor any other mortgage REIT that invests primarily in high-quality, residential mortgage-backed securities, without first obtaining the approval of a majority of our independent directors.

This Offering

This prospectus covers the resale of up to 11,500,000 shares of our common stock. We issued and sold 8,126,189 of these shares on June 11, 2003 and June 19, 2003, in a private offering to Friedman, Billings, Ramsey & Co., Inc., which we refer to as the initial purchaser, and 3,373,811 of these shares on June 11, 2003 and June 19, 2003 in a concurrent private offering to several other accredited investors. We refer to both of these offerings, collectively, as our private placement. We were advised by the initial purchaser that the shares it purchased were resold to qualified institutional buyers, as defined in Rule 144A under the Securities Act, institutional accredited investors, as defined in Rule 501 under the Securities Act, and/or to non-U.S. Persons, as defined in Regulation S under the Securities Act, initially at a price of $15.00 per share.

Common stock offered by the selling stockholders	11,500,000 shares
Common stock outstanding	24,841,146 shares
Use of proceeds	We will not receive any proceeds from the sale of the shares of common stock offered by this prospectus.
Trading	Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol LUM ; however, an active trading market for our shares might never develop.

The number of shares of our common stock shown as outstanding, above, is based on 24,841,146 shares outstanding on March 1, 2004, and excludes:

55,000 shares of our common stock issuable upon the exercise of options outstanding on March 1, 2004 with a weighted-average exercise price of $14.82 per share; and

943,505 additional shares of our common stock as of March 1, 2004 available for issuance under our 2003 stock incentive plan and 2003 outside advisors stock incentive plan.

Our Tax Status

We will elect to be taxed as a REIT under the Internal Revenue Code commencing with our taxable year ending December 31, 2003. Provided we qualify as a REIT, we generally will not be subject to U.S. federal corporate income tax on taxable income that we distribute to our stockholders. REITs are subject to a number of organizational and operational requirements, including a requirement that they currently distribute at least 90% of their annual REIT net taxable income. We face the risk that we might not be able to comply with all of the REIT requirements in the future. Failure to qualify as a REIT would render us subject to U.S. federal income tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates, and distributions to our stockholders would not be deductible. Even if we qualify for taxation as a REIT, we may be subject to certain U.S. federal, state, local and foreign taxes on our income and property. See the section titled Certain U.S. Federal Income Tax Consequences which is included in the prospectus accompanying this prospectus supplement.

Restrictions on Ownership of Our Stock

In order to facilitate our qualification as a REIT, our charter prohibits any stockholder from directly or indirectly owning more than 9.8% of the outstanding shares of any class or series of our stock. We adopted this restriction to promote compliance with the provisions of the Internal Revenue Code which limit the degree to which ownership of a REIT may be concentrated. See the section titled Description of Capital Stock Transfer Restrictions which is included in the prospectus accompanying this prospectus supplement.

Distributions

To avoid corporate income and excise tax and to maintain our qualification as a REIT, we intend to make quarterly distributions to our stockholders that will result in annual distributions of at least 90% of our REIT net taxable income, determined without regard to the deduction for dividends paid and by excluding any net capital gains. REIT net taxable income is calculated pursuant to standards in the Internal Revenue Code and will not necessarily be the same as our net income as calculated in accordance with generally accepted accounting principles, or GAAP. Our board of directors may, in its discretion, cause us to make additional distributions of cash legally available for that purpose. Our distributions from quarter to quarter will depend on our taxable earnings, financial condition and such other factors as our board of directors deems relevant. In the future, our board of directors may elect to adopt a dividend reinvestment plan.

Selling Stockholders, Concurrent Initial Public Offering and Lock-Up Agreements

Selling Stockholders. The holders of 11,500,000 shares of our common stock issued in a private placement in June 2003, or their transferees, have registration rights pursuant to a registration rights agreement we entered into on June 11, 2003, the initial closing date of the private placement. Those stockholders have the right to sell all or a portion of their shares of our common stock from time to time in this offering, subject to limitations. The names of those stockholders are included in this prospectus supplement. Of the 11,704,000 shares of common stock outstanding prior to our IPO, a total of 204,000 shares (held by our founders and their associates) are not salable pursuant to this prospectus supplement.

Initial Public Offering. Our IPO was filed on registration statement Form S-11, which was declared effective by the SEC on December 18, 2003. The underwriters subsequently exercised their over-allotment option in full and on December 24, 2003 we issued 13,110,000 shares of common stock for net proceeds of approximately $157.6 million, after estimated expenses and underwriting discounts and commissions.

Lock-Up Agreements. Pursuant to our registration rights agreement, the holders of the 11,500,000 shares of our common stock issued in our June 2003 private placement are, subject to various exceptions, restricted from selling any of their shares until February 17, 2004 (the 61st day after December 18, 2003, the date of our IPO prospectus) without the prior written consent of Friedman, Billings, Ramsey & Co., Inc. In connection with our June 2003 private placement, most of our directors and officers and some of our other stockholders, including Seneca, which collectively owned an aggregate of 297,448 shares of our common stock at that time, entered into individual lock-up agreements which, subject to various exceptions, prevent them from reselling their shares until 90 days after the effective date of the registration statement of which the prospectus accompanying this prospectus supplement is a part. Some of these shares were purchased in our June 2003 private placement and, as a result, are also subject to the 60-day lock-up restrictions described above. In addition, in connection with the IPO, our directors, officers and Seneca, who collectively own an aggregate of 401,409 shares of our common stock have entered into individual lock-up agreements which, subject to various exceptions, prevent them from reselling their shares until 180 days after December 18, 2003, the date of our IPO prospectus.

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Summary Financial Data

The following summary financial data are derived from audited financial statements as of April 25, 2003 (inception), June 30, 2003 and December 31, 2003 and for the period from April 26, 2003 through June 30, 2003 and for the period from April 26, 2003 through December 31, 2003, and unaudited financial statements as of September 30, 2003 (as restated), for the period April 26, 2003 through September 30, 2003 (as restated), for the three months ended September 30, 2003 (as restated) and for the three months ended December 31, 2003. The selected financial data should be read in conjunction with the more detailed information contained in the financial statements and notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this prospectus supplement. See Note 10 to the financial statements in the prospectus accompanying this prospectus supplement for a discussion of the restatement of the financial information below.

(dollars in thousands, except share and per share amounts)	For the period April 26, 2003 through December 31, 2003	For the three months ended December 31, 2003	For the three months ended September 30, 2003 (as restated)	For the period April 26, 2003 through June 30, 2003
Statement of Operations Data:				
Revenues:				
Net interest income:				
Interest income	$ 22,654	$ 11,205	$ 10,777	$ 672
Interest expense	9,009	4,518	4,327	164
Net interest income	13,645	6,687	6,450	508
Losses on sales of mortgage-backed securities	(7,831)		(7,831)	
Expenses:				
Management fee expense to related party	901	418	398	85
Incentive fee expense to related party	980	367	613	
Salaries and benefits	99	59	41	
Professional services	477	130	123	224
Board of directors expense	117	56	39	22
Insurance expense	291	128	128	35
Custody expense	115	65	47	3
Other general and administrative expenses	73	60	10	2
Total expenses	3,053	1,283	1,399	371
Net income (loss)	$ 2,761	$ 5,404	$ (2,780)	$ 137

Basic and diluted earnings (loss) per share	$ 0.27	$ 0.40	$ (0.24)	$ 0.04
Weighted-average number of shares outstanding, basic	10,139,280	13,414,000	11,704,000	3,393,394
Weighted-average number of shares outstanding, diluted	10,139,811	13,414,260	11,704,000	3,393,394

(dollars in thousands, except per share amounts)	December 31, 2003	September 30, 2003 (as restated)	June 30, 2003	April 25, 2003 (inception)
Balance Sheet Data:				
Mortgage-backed securities available for sale, at fair value	$ 352,123	$ 108,886	$ 496,630	$
Mortgage-backed securities pledged as collateral, at fair value	1,809,822	1,496,209	1,217,326	
Total mortgage-backed securities, at fair value	2,161,945	1,605,095	1,713,956	
Total assets	2,179,340	1,831,082	1,719,447	1
Repurchase agreements and margin debt	1,728,973	1,472,875	1,154,939	
Unsettled security purchases	156,127	215,742	407,777	
Total liabilities	1,896,844	1,691,631	1,564,199	
Accumulated other comprehensive loss	(26,510)	(18,248)	(4,616)	
Total stockholders equity	282,496	139,451	155,248	1
Book value per share	$ 11.38	$ 11.91	$ 13.26	$ 0.001

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RISK FACTORS

You should carefully consider the risks described below before making an investment decision. Our business, financial condition or results of operations could be harmed by any of these risks. Similarly, these risks could cause the market price of our common stock to decline and you might lose all or part of your investment. Our forward-looking statements in this prospectus supplement and the accompanying prospectus are subject to the following risks and uncertainties. Our actual results could differ materially from those anticipated by our forward-looking statements as a result of the risk factors below. The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we currently deem immaterial might also impair our business operations.

Risks Related to Our Business

We have a limited operating history and might not be able to operate our business or implement our operating policies and strategies successfully.

We began operations in June of 2003, and we have a limited operating history. The results of our operations will depend on many factors, including the availability of opportunities for the acquisition of mortgage-related assets, the level and volatility of interest rates, readily accessible short- and long-term funding alternatives in the financial markets and economic conditions. Moreover, delays in investing our net proceeds of our initial public offering may cause our performance to be weaker than other fully invested mortgage REITs pursuing comparable investment strategies. You will not have the opportunity to evaluate the manner in which we invest or the economic merits of particular assets to be acquired. Furthermore, we face the risk that we might not successfully operate our business or implement our operating policies and strategies as described in this prospectus supplement.

Our investment guidelines permit us to invest up to 10% of our assets in unrated mortgage-related assets, including mortgage-backed securities rated below investment-grade, which carry a greater likelihood of default or rating downgrade than investments in investment-grade mortgage-backed securities and may cause us to suffer losses.

Our asset acquisition policy provides us with the ability to acquire significant amounts of lower credit quality mortgage-related assets, including mortgage-backed securities that are not rated at least investment grade by at least one nationally-recognized statistical rating organization. Under our policy, up to 10% of our total assets may be non-investment grade mortgage-backed securities or other investments such as leveraged mortgage derivative securities, shares of other REITs, mortgage loans or other mortgage-related investments. If we acquire non-investment-grade mortgage-backed securities, we are more likely to incur losses because the mortgages underlying those securities are made to borrowers possessing lower-quality credit. While all agency certificates are subject to a risk of default, that risk is greater with non-investment grade mortgage-backed securities. In addition, the rating agencies are more likely to downgrade the credit quality of those securities, which would reduce the value of those securities.

Interest rate mismatches between our adjustable-rate and hybrid adjustable-rate mortgage-backed securities and the borrowings used to fund our purchases of such mortgage-backed securities might reduce our net income or result in a loss during periods of changing interest rates.

We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. The mortgages underlying adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis, based upon market-based indices of interest rates such as U.S. Treasury bonds or LIBOR. The mortgages underlying hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter their interest rates reset periodically similar to the mortgages underlying adjustable-rate mortgage-backed securities. We have funded our acquisitions and expect to fund our future acquisitions of adjustable-rate and hybrid adjustable-rate mortgage-backed securities in part with borrowings that have interest rates based on indices and repricing terms similar to, but with shorter maturities than, the interest rate indices and repricing terms of the adjustable-rate and hybrid adjustable-rate mortgage-backed securities. On December 31, 2003, 97.5% of our investment portfolio was invested in adjustable-rate or hybrid adjustable-rate mortgage-backed securities having a weighted-average term to next rate adjustment of approximately 40 months, while our borrowings had a weighted-average term of approximately 145 days. After consideration of the duration on our Eurodollar futures contracts, our weighted-average maturity was 255 days. The phrase weighted average term to next rate adjustment refers to the average of the periods of time that must elapse before the interest rates adjust for all of the mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities in our portfolio, which average is weighted in proportion to the book values of the applicable securities. During periods of changing interest rates, this interest rate mismatch between our assets and liabilities could reduce or eliminate our net income and distributions to our stockholders and could cause us to suffer a loss.

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Accordingly, in a period of rising interest rates, we could experience a decrease in, or elimination of, net income or a net loss because the interest rates on our borrowings adjust faster than the interest rates on our adjustable-rate mortgage-backed securities.

Increased levels of prepayments on the mortgages underlying our mortgage-backed securities might decrease our net interest income or result in a net loss.

The mortgage-backed securities that we acquire generally represent interests in pools of mortgage loans. The principal and interest payments we receive from our mortgage-backed securities are generally funded by the payments that mortgage borrowers make on those underlying mortgage loans. When borrowers pre-pay their mortgage loans sooner than expected, corresponding prepayments on the mortgage-backed securities occur sooner than expected by the marketplace. Sooner-than-expected prepayments could harm our results of operations in the following ways, among others:

We seek to purchase mortgage-backed securities that we believe to have favorable risk-adjusted expected returns relative to market interest rates at the time of purchase. If the coupon interest rate for a mortgage-backed security is higher than the market interest rate at the time it is purchased, then that mortgage-backed security will be acquired at a premium to its par value. In accordance with applicable accounting rules, we are required to amortize any premiums or discounts related to our mortgage-backed securities over their expected terms. The amortization of a premium reduces interest income, while the amortization of a discount increases interest income. The expected terms for mortgage-backed securities are a function of the prepayment rates for the mortgages underlying the mortgage-backed securities. Mortgage-backed securities that are at a premium to their par value are more likely to experience prepayment of some or all of their principal through refinancings. If the mortgages underlying our premium mortgage-backed securities are prepaid in whole or in part more quickly than their respective maturity dates, then we must also amortize their respective premiums more quickly, which would decrease our net interest income and harm our profitability.

A substantial portion of our adjustable-rate mortgage-backed securities may bear interest at rates that are lower than their fully-indexed rates, which refers to their applicable index rates plus a margin. If an adjustable-rate mortgage-backed security is prepaid prior to or soon after the time of adjustment to a fully-indexed rate, we will have held that mortgage-backed security while it was less profitable and lost the opportunity to receive interest at the fully-indexed rate over the remainder of its expected life.

If we are unable to acquire new mortgage-backed securities to replace the prepaid mortgage-backed securities, our financial condition, results of operations and cash flow may suffer and we could incur losses.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayment rates also may be affected by other factors, including, without limitation, conditions in the housing and financial markets, general economic conditions and the relative interest rates on adjustable-rate and fixed-rate mortgage loans. While we seek to minimize prepayment risk, we must balance prepayment risk against other risks and the potential returns of each investment when selecting investments. No strategy can completely insulate us from prepayment or other such risks.

We may incur increased borrowing costs related to repurchase agreements that would harm our results of operations.

Our borrowing costs under repurchase agreements are generally adjustable and correspond to short-term interest rates, such as LIBOR or a short-term Treasury index, plus or minus a margin. The margins on these borrowings over or under short-term interest rates may vary depending upon a number of factors, including, without limitation:

- the movement of interest rates;
- the availability of financing in the market; and
- the value and liquidity of our mortgage-backed securities.

Most of our borrowings are collateralized borrowings in the form of repurchase agreements. If the interest rates on these repurchase agreements increase, our results of operations will be harmed and we may have losses.

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Interest rate caps related to our adjustable-rate and hybrid adjustable-rate mortgage-backed securities may reduce our income or cause us to suffer a loss during periods of rising interest rates.

The mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities are typically subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount that the interest rate of a mortgage can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through the maturity of a mortgage. As of December 31, 2003, 97.5% of our mortgage-backed securities were based on adjustable-rate or hybrid adjustable-rate mortgages, substantially all of which were subject to interest rate caps. The percentage of adjustable-rate and hybrid adjustable-rate mortgage-backed securities in our investment portfolio which are subject to periodic interest rate caps every six months or annually were 16.6% and 80.9%, respectively.

Our borrowings are not subject to similar restrictions. The periodic adjustments to the interest rates of the mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities are based on changes in an objective index. Substantially all of the mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities adjust their interest rates based on one of two main indices, the U.S. Treasury index, a monthly or weekly average yield of benchmark U.S. Treasury securities as published by the Federal Reserve Board, or LIBOR, the interest rate that banks in London offer for deposits in London of U.S. dollars. The percentages of the mortgages underlying the adjustable-rate and hybrid adjustable-rate mortgage-backed securities in our investment portfolio as of December 31, 2003 with interest rates that reset based on the U.S. Treasury or LIBOR indices were 39.1% and 58.4%, respectively.

Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while interest rate caps could limit the increases in the yields on our adjustable-rate and hybrid adjustable-rate mortgage-backed securities. This problem is magnified for adjustable-rate and hybrid adjustable-rate mortgage-backed securities that are not fully indexed. Further, some of the mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we may receive less cash income on adjustable-rate and hybrid adjustable-rate mortgage-backed securities than we need to pay interest on our related borrowings. These factors could reduce our net interest income or cause us to suffer a net loss.

We might experience reduced net interest income or a loss from holding fixed-rate investments during periods of rising interest rates.

A significant portion of our investment portfolio consists of hybrid adjustable-rate mortgage-backed securities. As of December 31, 2003, 88.9% of our investment portfolio consisted of hybrid adjustable-rate mortgage-backed securities. We may also invest in fixed-rate mortgage-backed securities from time to time, however, as of December 31, 2003, none of our portfolio consisted of fixed-rate mortgage-backed securities. We fund our acquisition of fixed-rate mortgage-backed securities, including those based on balloon maturity and hybrid adjustable-rate mortgages, in part with short-term repurchase agreements and term loans. During periods of rising interest rates, our costs associated with borrowings used to fund the acquisition of fixed-rate mortgage-backed securities are subject to increases while the income we earn from these assets remains substantially fixed. This would reduce and could eliminate the net interest spread between the fixed-rate mortgage-backed securities that we purchase and our borrowings used to purchase them, which would reduce our net interest income and could cause us to suffer a loss.

Our leverage strategy increases the risks of our operations, which could reduce our net income and the amount available for distributions or cause us to suffer a loss.

We generally seek to borrow between eight and 12 times the amount of our equity, although at times our borrowings may be above or below this amount. We incur this indebtedness by borrowing against a substantial portion of the market value of our mortgage-backed securities. Our total indebtedness, however, is not expressly limited by our policies and will depend on our and our prospective lender s estimate of the stability of our portfolio s cash flow. We face the risk that we might not be able to meet our debt service obligations or a lender s margin requirements from our income and, to the extent we cannot, we might be forced to liquidate some of our assets at disadvantageous prices. Our use of leverage amplifies the risks associated with other risk factors, which could reduce our net income and the amount available for distributions or cause us to suffer a loss. For example:

A majority of our borrowings are secured by our mortgage-backed securities, generally under repurchase agreements. A decline in the market value of the mortgage-backed securities used to secure these debt obligations could limit our ability to borrow or result in lenders requiring us to pledge additional collateral to secure our borrowings. In that situation, we could be required to sell mortgage-backed securities under adverse market conditions in order to obtain the additional collateral required by the lender. If these sales are made at prices lower than the carrying value of the mortgage-backed securities, we would experience losses.

A default under a mortgage-related asset that constitutes collateral for a loan could also result in an involuntary liquidation of the mortgage-related asset, including any cross-collateralized mortgage-backed securities. This would result in a loss to us of the difference between the value of the mortgage-related asset upon liquidation and the amount borrowed against the mortgage-related asset.

To the extent we are compelled to liquidate qualified REIT assets to repay debts, our compliance with the REIT rules regarding our assets and our sources of income could be negatively affected, which would jeopardize our status as a REIT. Losing our REIT status would cause us to lose tax advantages applicable to REITs and would decrease our overall profitability and distributions to our stockholders.

If we experience losses as a result of our leverage policy, such losses would reduce the amounts available for distribution to our stockholders.

We might not be able to use derivatives to mitigate our interest rate and prepayment risks.

Our policies permit us to enter into interest rate swaps, caps and floors and other derivative transactions to help us reduce our interest rate and prepayment risks. As of December 31, 2003, we were engaged in short sales of Eurodollar futures contracts in order to hedge the impact of changes in interest rates on our liability costs. In the future, these transactions might mitigate our interest rate and prepayment risks, but cannot eliminate these risks. Moreover, the use of derivative transactions could have a negative impact on our earnings and our status as a REIT, and, therefore, our use of such derivatives could be limited.

We may enter into ineffective derivative transactions or other hedging activities that may reduce our net interest income or cause us to suffer losses.

Our policies permit us to, but we are not required to, enter into derivative transactions such as interest rate swaps, caps and floors and other derivative transactions to help us seek to reduce our interest rate and prepayment risks. The effectiveness of any derivative transactions will depend significantly upon whether we correctly quantify the interest rate or prepayment risks being hedged, our execution of and ongoing monitoring of our hedging activities, and the treatment of such hedging activities for GAAP accounting purposes.

As of December 31, 2003, we were engaged in short sales of Eurodollar futures contracts in order to hedge the impact of changes in interest rates on our liability costs. In the case of these hedges, and any other future efforts to hedge the effects of interest rate changes on our liability costs, if we enter into hedging instruments that have higher interest rates embedded in them as a result of the forward yield curve, and at the end of the term of these hedging instruments the spot market interest rates for the liabilities that we hedged are actually lower, then we will have locked in higher interest rates for our liabilities than would be available in the spot market at the time and this could result in a narrowing of our net interest rate margin or result in losses. In some situations, we may sell assets or hedging instruments at a loss in order to maintain adequate liquidity.

In addition, we apply SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, and record derivatives at fair value. If the derivatives meet the criteria to be accounted for as hedging transactions, the effects of the transactions could be materially different as to timing than if they do not qualify as hedges, and this may cause a narrowing of our net interest rate margin or result in losses.

An increase in interest rates might adversely affect our book value.

We use changes in 10-year U.S. Treasury yields as a reference indicator for changes in interest rates because it is a common market benchmark. Increases in the general level of interest rates can cause the fair market value of our assets to decline, particularly those mortgage-backed securities whose underlying mortgages have fixed-rate components. Our fixed-rate mortgage securities and our hybrid adjustable-rate mortgage-backed securities (during the fixed-rate component of the mortgages underlying such securities) will generally be more negatively affected by such increases than our adjustable-rate mortgage securities. In accordance with GAAP, we will be required to reduce the carrying value of our mortgage-backed securities by the amount of any decrease in the fair value of our mortgage-backed securities compared to their respective amortized costs. If unrealized losses in fair value occur, we will have to either reduce current earnings or reduce stockholders equity without immediately affecting current earnings, depending on how we classify such mortgage-backed securities under GAAP. In either case, our net book value will decrease to the extent of any realized or unrealized losses in fair value.

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We may invest in leveraged mortgage derivative securities that generally experience greater volatility in market prices, and thus expose us to greater risk with respect to their rate of return.

We may acquire leveraged mortgage derivative securities that expose us to a high level of interest rate risk. The characteristics of leveraged mortgage derivative securities cause those securities to experience greater volatility in their market prices. Thus, acquisition of leveraged mortgage derivative securities will expose us to the risk of greater volatility in our portfolio, which could reduce our net income and harm our overall results of operations.

We depend on borrowings to purchase mortgage-related assets and reach our desired amount of leverage. If we fail to obtain or renew sufficient funding on favorable terms or at all, we will be limited in our ability to acquire mortgage-related assets, which will harm our results of operations.

We depend on short-term borrowings to fund acquisitions of mortgage-related assets and reach our desired amount of leverage. Accordingly, our ability to achieve our investment and leverage objectives depends on our ability to borrow money in sufficient amounts and on favorable terms. In addition, we must be able to renew or replace our maturing short-term borrowings on a continuous basis. We depend on a few lenders to provide the primary credit facilities for our purchases of mortgage-related assets. In addition, our existing indebtedness may limit our ability to make additional borrowings. If our lenders do not allow us to renew our borrowings or we cannot replace maturing borrowings on favorable terms or at all, we might have to sell our mortgage-related assets under adverse market conditions, which would harm our results of operations and may result in permanent losses.

Possible market developments could cause our lenders to require us to pledge additional assets as collateral. If our assets are insufficient to meet the collateral requirements, we might be compelled to liquidate particular assets at inopportune times and at disadvantageous prices.

Possible market developments, including a sharp or prolonged rise in interest rates, a change in prepayment rates or increasing market concern about the value or liquidity of one or more types of mortgage-backed securities in which our portfolio is concentrated, might reduce the market value of our portfolio, which might cause our lenders to require additional collateral. Any requirement for additional collateral might compel us to liquidate our assets at inopportune times and at disadvantageous prices, thereby harming our operating results. If we sell mortgage-backed securities at prices lower than the carrying value of the mortgage-backed securities, we would experience losses.

Our use of repurchase agreements to borrow funds may give our lenders greater rights in the event that either we or any of our lenders file for bankruptcy.

Our borrowings under repurchase agreements may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay if we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that our lender files for bankruptcy. Thus, the use of repurchase agreements exposes our pledged assets to risk in the event of a bankruptcy filing by either our lender or us.

Because the assets that we acquire might experience periods of illiquidity, we might be prevented from selling our mortgage-related assets at opportune times and prices.

We bear the risk of being unable to dispose of our mortgage-related assets at advantageous times and prices or in a timely manner because mortgage-related assets generally experience periods of illiquidity. The lack of liquidity might result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale. If we are unable to sell our mortgage-related assets at opportune times, we might suffer a loss and/or reduce our distributions.

Our board of directors may change our operating policies and strategies without prior notice or stockholder approval and such changes could harm our business and results of operations and the value of our stock.

Our board of directors has the authority to modify or waive our current operating policies and our strategies (including our election to operate as a REIT) without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, operating results and value of our stock. However, the effects might be adverse.

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Competition might prevent us from acquiring mortgage-backed securities at favorable yields, which would harm our results of operations.

Our net income depends on our ability to acquire mortgage-backed securities at favorable spreads over our borrowing costs. In acquiring mortgage-backed securities, we compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, mutual funds, other lenders and other entities that purchase mortgage-backed securities, many of which have greater financial resources than we do. As a result, we may not be able to acquire sufficient mortgage-backed securities at favorable spreads over our borrowing costs, which would harm our results of operations.

Defaults on the mortgage loans underlying our mortgage-backed securities may reduce the value of our investment portfolio and may harm our results of operations.

We bear the risk of any losses resulting from any defaults on the mortgage loans underlying the mortgage-backed securities in our investment portfolio. Many of the mortgage-backed securities that we obtain will have one or more forms of credit enhancement provided by third parties, such as insurance against risk of loss due to default on the underlying mortgage loans or bankruptcy, fraud and special hazard losses. To the extent that third parties have been contracted to insure against these types of losses, the value of such insurance will depend in part on the creditworthiness and claims-paying ability of the insurer and the timeliness of reimbursement in the event of a default on the underlying obligations. Further, the insurance coverage for various types of losses is limited in amount, and losses in excess of these limitations would be borne by us.

Other mortgage-backed securities that we purchase will be subject to limited guarantees of the payment of limited amounts of principal and interest on mortgage loans underlying such mortgage-backed securities, either by federal government agencies, including Ginnie Mae, by federally-chartered corporations, including Fannie Mae and Freddie Mac, or by other corporate guarantors. While Ginnie Mae s obligations are backed by the full faith and credit of the United States, the obligations of Fannie Mae and Freddie Mac and other corporate guarantors are solely their own. As a result, a substantial deterioration in the financial strength of Fannie Mae, Freddie Mac or other corporate guarantors could increase our exposure to future delinquencies, defaults or credit losses on our holdings of Fannie Mae or Freddie Mac-backed mortgage-backed securities or other corporate-backed mortgage-backed securities, and could harm our results of operations. In addition, while Freddie Mac guarantees the eventual payment of principal, it does not guarantee the timely payment thereof, and our results of operations may be harmed if borrowers are late or delinquent in their payments on mortgages underlying Freddie Mac-backed mortgage-backed securities. Moreover, Fannie Mae, Freddie Mac, Ginnie Mae and other corporate guarantees relate only to payments of limited amounts of principal and interest on the mortgages underlying such agency-backed or corporate-backed securities, and do not guarantee the market value of such mortgage-backed securities or the yields on such mortgage-backed securities. As a result, we remain subject to interest rate risks, prepayment risks, extension risks and other risks associated with our investment in such mortgage-backed securities and may experience losses in our investment portfolio.

We remain subject to losses despite our strategy of investing in highly-rated mortgage-backed securities.

Our investment guidelines provide that at least 90% of our assets must be invested in mortgage-backed securities that are either agency-backed or are rated at least investment grade by at least one rating agency. While highly-rated mortgage-backed securities are generally subject to a lower risk of default than lower credit quality mortgage-backed securities and may benefit from third-party credit enhancements such as insurance or corporate guarantees, there is no assurance that such mortgage-backed securities will not be subject to credit losses. Furthermore, ratings are subject to change over time as a result of a number of factors, including greater than expected delinquencies, defaults or credit losses, or a deterioration in the financial strength of corporate guarantors, any of which may reduce the market value of such securities. Furthermore, ratings do not take into account the reasonableness of the issue price, interest risks, prepayment risks, extension risks or other risks associated with such mortgage-backed securities. As a result, while we attempt to mitigate our exposure to credit risk on a relative basis by focusing on highly-rated mortgage-backed securities, we cannot eliminate such credit risks and remain subject to other risks to our investment portfolio and may suffer losses, which may harm the market price of our common stock.

Decreases in the value of the property underlying our mortgage-backed securities might decrease the value of our assets.

The mortgage-backed securities in which we invest are secured by underlying real property interests. To the extent that the value of the property underlying our mortgage-backed securities decreases, our security might be impaired, which might decrease the value of our assets.

Insurance will not cover all potential losses on the underlying real property and the absence thereof may harm the value of our assets.

Under our asset acquisition policy, we are permitted to invest up to a maximum of 10% of our total assets in assets other than mortgage-backed securities guaranteed by federal agencies or federally chartered entities such as Fannie Mae, Freddie Mac or Ginnie Mae, or rated as at least investment grade by a nationally recognized statistical rating agency. Mortgage loans fall outside of this category of investments under our investment guidelines and are subject to the 10% limitation. If we elect in the future to purchase mortgage loans, we may require that each of the mortgage loans that we purchase include comprehensive insurance covering the underlying real property, including liability, fire and extended coverage. There are certain types of losses, however, generally of a catastrophic nature, such as earthquakes, floods and hurricanes, that may be uninsurable or not economically insurable. Inflation, changes in building codes and ordinances, environmental considerations, and other factors also might make it infeasible to use insurance proceeds to replace a property if it is damaged or destroyed. Under such circumstances, the insurance proceeds, if any, might not be adequate to restore the economic value of the underlying real property, which might impair our security and decrease the value of our assets.

Distressed mortgage loans have higher risk of future default.

If we elect in the future to purchase mortgage loans, we may purchase distressed mortgage loans as well as mortgage loans that have had a history of delinquencies. These distressed mortgage loans may be in default or may have a greater than normal risk of future defaults and delinquencies, as compared to a pool of newly-originated, high quality loans of comparable type, size and geographic concentration. Returns on an investment of this type depend on accurate pricing of such investment, the borrower s ability to make required payments or, in the event of default, the ability of the loan s servicer to foreclose and liquidate the mortgage loan. We cannot assure you that the servicer will be able to liquidate a defaulted mortgage loan in a cost-effective manner, at an advantageous price or in a timely manner.

Subordinated loans on real estate are subject to higher risks.

If we elect in the future to purchase mortgage loans, we may acquire loans secured by commercial properties, including loans that are subordinate to first liens on the underlying commercial real estate. Subordinated mortgage loans are subject to greater risks of loss than first lien mortgage loans. An overall decline in the real estate market could reduce the value of the real property securing such loans such that the aggregate outstanding balance of the second-lien loan and the balance of the more senior loan on the real property exceed the value of the real property.

We depend on our key personnel and the loss of any of our key personnel could severely and detrimentally affect our operations.

We depend on the diligence, experience and skill of our officers and the people working on behalf of our manager for the selection, acquisition, structuring and monitoring of our mortgage-related assets and associated borrowings. Our key officers include Gail Seneca, Albert Gutierrez, Christopher Zyda, Andrew Chow and Troy Grande. We have not entered into employment agreements with our senior officers other than Mr. Zyda, who is our Senior Vice President and Chief Financial Officer. With the exception of Mr. Zyda, we do not currently employ personnel dedicated solely to our business, and our officers are free to engage in competitive activities in our industry. The loss of any key person could harm our business, financial condition, cash flow and results of operations.

Risks Related to Our Manager

Seneca has not managed a REIT and we cannot assure you that Seneca s past experience will be sufficient to successfully manage our business as a REIT.

Seneca Capital Management LLC has not previously managed a REIT, and does not have any experience in complying with the income, asset and other limitations imposed by the REIT provisions of the Internal Revenue Code. Those provisions are complex and the failure to comply with those provisions in a timely manner could prevent us from qualifying as a REIT or could force us to pay unexpected taxes and penalties. In such event, our net income would be reduced and we could incur a loss.

Our manager has significant influence over our affairs, and might cause us to engage in transactions that are not in our or our stockholders best interests.

In addition to managing us and having at least two of its designees as members of our board, Seneca provides advice on our operating policies and strategies. Seneca may also cause us to engage in future transactions with Seneca and its affiliates, subject to the approval of, or guidelines approved by, the independent members of our board of directors. Our directors, however, rely

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primarily on information supplied by our manager in reaching their determinations. Accordingly, our manager has significant influence over our affairs, and may cause us to engage in transactions which are not in our best interest.

Our manager and its affiliates might allocate mortgage-related opportunities to other entities, and thus might divert attractive investment opportunities away from us.

Our operations and assets are managed by specified individuals at Seneca. Seneca and its affiliates, including some of our officers, manage portfolios for parties unrelated to us. These multiple responsibilities might create conflicts of interest for Seneca and these individuals if they are presented with opportunities that might benefit us and their other clients. Seneca and these individuals must allocate investments among our portfolio and their other clients by determining the entity or account for which the investment is most suitable. In making this determination, Seneca and these individuals consider the investment strategy and guidelines of each entity or account with respect to acquisition of assets, leverage, liquidity and other factors that Seneca and these individuals determine appropriate. However, Seneca and those working on its behalf have no obligation to make any specific investment opportunities available to us and the above-mentioned conflicts of interest might result in decisions or allocations of investments that are not in our or our stockholders best interests.

We will pay Seneca incentive compensation based on our portfolio s performance. This arrangement may lead Seneca to recommend riskier or more speculative investments in an effort to maximize its incentive compensation.

In addition to its base management fee, Seneca earns incentive compensation for each fiscal quarter equal to a specified percentage of the amount by which our return on equity, before deducting incentive compensation, exceeds a return based on the 10 year U.S. Treasury rate plus 2%. The percentage for this calculation is the weighted average of the following percentages based on our average net invested assets for the period:

20% for the first $400 million of our average net invested assets; and

10% of our average net invested assets in excess of $400 million.

Pursuant to the formula for calculating Seneca s incentive compensation, Seneca shares in our profits but not in our losses. Consequently, as Seneca evaluates different mortgage-backed securities and other investments for our account, there is a risk that Seneca will cause us to assume more risk than is prudent in an attempt to increase its incentive compensation. Other key criteria related to determining appropriate investments and investment strategies, including the preservation of capital, might be under-weighted if Seneca focuses exclusively or disproportionately on maximizing its income.

We may be obligated to pay Seneca incentive compensation even if we incur a loss.

Pursuant to the Management Agreement, Seneca is entitled to receive incentive compensation for each fiscal quarter in an amount equal to a tiered percentage of the excess of our taxable income for that quarter (before deducting incentive compensation, net operating losses and certain other items) above a threshold return for that quarter. In addition, the Management Agreement further provides that our taxable income for incentive compensation purposes excludes net capital losses that we may incur in the fiscal quarter, even if such capital losses result in a net loss on our statement of operations for that quarter. Thus, we may be required to pay Seneca incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter.

During periods of declining market prices for shares of our common stock, we may be required to issue greater numbers of shares to Seneca for the same amount of incentive compensation arising under the Management Agreement, which will have a dilutive effect on our stockholders that may harm the market price of our

common stock.

Pursuant to the terms of the Management Agreement, the incentive compensation payable to Seneca for each fiscal quarter is paid one-half in cash and one-half in restricted shares of our common stock. The number of shares to be issued to Seneca is based on (a) one-half of the total incentive compensation for the period, divided by (b) the average of the closing prices of the common stock over the 30 day period ending three days prior to the grant date, less a fair market value discount determined by our board of directors. During periods of declining market prices for shares of our common stock, we may be required to issue more shares to Seneca for the same amount of incentive compensation. Although these shares will initially be subject to restrictions on transfer which lapse ratably over a three-year period, the issuance of these shares will have a dilutive effect on our stockholders which may harm the market price of our common stock.

Because Seneca might receive a significant fee if we terminate the Management Agreement, economic considerations might preclude us from terminating the Management Agreement in the event that Seneca fails to meet our expectations.

If we terminate the Management Agreement without cause or because we decide to manage our company internally or if Seneca terminates the management in the event of a change of control, then we will have to pay a significant fee to Seneca. The amount of the fee depends on whether:

- we terminate the Management Agreement without cause in connection with a decision to manage our portfolio internally, in which case we will be obligated to pay to Seneca a fee equal to the highest amount of management fees incurred in a particular year during the then three most recent years; or

- our decision to terminate the Management Agreement without cause is for a reason other than our decision to manage our portfolio internally, in which case we will be obligated to pay Seneca an amount equal to two times the highest amount of management fees incurred in a particular year during the then three most recent years.

In each of the above cases, Seneca will also receive accelerated vesting of the equity component of its incentive compensation. The actual amount of such fee cannot be known at this time because it is based in part on the performance of our portfolio of mortgage-backed securities. Paying this fee would reduce significantly the cash available for distribution to our stockholders and might cause us to suffer a net operating loss. Consequently, terminating the Management Agreement might not be advisable even if we determine that it would be more efficient to operate with an internal management structure or if we are otherwise dissatisfied with Seneca s performance.

Investors may not be able to estimate with certainty the aggregate fees and expense reimbursements that will be paid to Seneca under the Management Agreement and the cost-sharing agreement due to the time and manner in which Seneca s incentive compensation and expense reimbursements are determined.

Seneca may be entitled to substantial fees pursuant to the Management Agreement. Seneca s base management fee is calculated as a percentage of our average net worth. Seneca s incentive compensation is calculated as a tiered percentage of our taxable income (before deducting certain items) in excess of a threshold amount of taxable income and is indeterminable in advance of a particular period. Since future payments of base management fees, incentive compensation and expense reimbursements are determined at future dates based upon our then-applicable average net worth, results of operations and actual expenses incurred by Seneca, such fees and expense reimbursements cannot be estimated with mathematical certainty. Any base management fees, incentive compensation or expense reimbursements payable to Seneca may be materially greater or less than the historical amounts and we can provide no assurance at this time as to the amount of any such base management fee, incentive compensation or expense reimbursements that may be payable to Seneca in the future.

Seneca may render services to other mortgage investors, which could reduce the amount of time and effort that Seneca devotes to us.

Our Management Agreement with Seneca does not restrict the right of Seneca, any persons working on its behalf or any of its affiliates, to carry on their respective businesses, including the rendering of advice to others regarding the purchase of mortgage-backed securities that would meet our investment criteria. In addition, the Management Agreement does not specify a minimum time period that Seneca and its personnel must devote to managing our investments. The ability of Seneca to engage in these other business activities, and specifically to manage mortgage-related assets for third parties, could reduce the time and effort it spends managing our portfolio to the detriment of our investment returns.

Seneca s liability is limited under the Management Agreement, and we have agreed to indemnify Seneca against certain liabilities.

Seneca has not assumed any responsibility to us other than to render the services described in the Management Agreement, and will not be responsible for any action of our board of directors in declining to follow Seneca s advice or recommendations. Seneca and its directors, officers and employees will not be liable to us for acts performed by its officers, directors, or employees in accordance with and pursuant to the Management Agreement, except for acts constituting gross negligence, recklessness, willful misconduct or active fraud in connection with their duties under the Management Agreement. We have agreed to indemnify Seneca and its directors, officers and employees with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of Seneca not constituting gross negligence, recklessness, willful misconduct or active fraud.

Legal and Tax Risks

If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.

Qualification as a REIT involves the application of highly technical and complex U.S. federal income tax code provisions for which only a limited number of judicial or administrative interpretations exist. Accordingly, it is not certain we will be able to become and remain qualified as a REIT for U.S. federal income tax purposes. Even a technical or inadvertent mistake could jeopardize our REIT status. Furthermore, Congress or the Internal Revenue Service, or IRS, might change tax laws or regulations and the courts might issue new rulings, in each case potentially having retroactive effect, that could make it more difficult or impossible for us to qualify as a REIT. If we fail to qualify as a REIT in any tax year, then:

- we would be taxed as a regular domestic corporation, which, among other things, means that we would be unable to deduct distributions to stockholders in computing taxable income and we would be subject to U.S. federal income tax on our taxable income at regular corporate rates;

- any resulting tax liability could be substantial, would reduce the amount of cash available for distribution to stockholders, and could force us to liquidate assets at inopportune times, causing lower income or higher losses than would result if these assets were not liquidated; and

- unless we were entitled to relief under applicable statutory provisions, we would be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which we lost our qualification and, thus, our cash available for distribution to our stockholders would be reduced for each of the years during which we did not qualify as a REIT.

Even if we remain qualified as a REIT, we might face other tax liabilities that reduce our cash flow. Further, we might be subject to federal, state and local taxes on our income and property. Any of these taxes would decrease cash available for distribution to our stockholders.

Complying with REIT requirements might cause us to forego otherwise attractive opportunities.

In order to qualify as a REIT for U.S. federal income tax purposes, we must satisfy tests concerning, among other things, our sources of income, the nature and diversification of our mortgage-backed securities, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to our stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may cause us to forego opportunities we would otherwise pursue.

In addition, the REIT provisions of the Internal Revenue Code impose a 100% tax on income from prohibited transactions. Prohibited transactions generally include sales of assets that constitute inventory or other property held for sale in the ordinary course of a business, other than foreclosure property. This 100% tax could impact our desire to sell mortgage-backed securities at otherwise opportune times if we believe such sales could be considered a prohibited transaction.

Complying with REIT requirements may limit our ability to hedge effectively.

The existing REIT provisions of the Internal Revenue Code substantially limit our ability to hedge mortgage-backed securities and related borrowings. Under these provisions, our annual income from qualified hedges, together with any other income not generated from qualified REIT real estate assets, is limited to less than 25% of our gross income. In addition, we must limit our aggregate income from hedging and services from all sources, other than from qualified REIT real estate assets or qualified hedges, to less than 5% of our annual gross income. As a result, we might in the future have to limit our use of advantageous hedging techniques. This could leave us exposed to greater risks associated with changes in interest rates than we would otherwise want to bear. If we were to violate the 25% or 5% limitations, we might have to pay a penalty tax equal to the amount of our income in excess of those limitations, multiplied by a fraction intended to reflect our profitability. If we fail to satisfy the 25% or 5% limitations, unless our failure was due to reasonable cause and not due to willful neglect, we could lose our REIT status for federal income tax purposes.

Complying with REIT requirements may force us to liquidate otherwise attractive investments.

In order to qualify as a REIT, we must ensure that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, generally, no more than 5% of the value of our assets can consist of the securities of any one issuer. If we fail to comply with these requirements, we must dispose of a portion of our assets within 30 days after the end of the calendar quarter in order to avoid losing our REIT status and suffering adverse tax consequences.

Complying with REIT requirements may force us to borrow to make distributions to our stockholders.

As a REIT, we must distribute 90% of our annual taxable income (subject to certain adjustments) to our stockholders. From time to time, we might generate taxable income greater than our net income for financial reporting purposes from, among other things, amortization of capitalized purchase premiums, or our taxable income might be greater than our cash flow available for distribution to our stockholders. If we do not have other funds available in these situations, we might be unable to distribute 90% of our taxable income as required by the REIT rules. In that case, we would need to borrow funds, sell a portion of our mortgage-backed securities potentially at disadvantageous prices or find another alternative source of funds. These alternatives could increase our costs or reduce our equity and reduce amounts available to invest in mortgage-backed securities.

Failure to maintain an exemption from the Investment Company Act, would harm our results of operations.

We intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, as amended. If we fail to qualify for this exemption, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as described in this prospectus supplement.

The Investment Company Act exempts entities that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Under the current interpretation of the SEC staff, in order to qualify for this exemption, we must maintain at least 55% of our assets directly in these qualifying real estate interests. Mortgage-backed securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as separate from the underlying mortgage loans and, thus, may not qualify for purposes of the 55% requirement. Therefore, our ownership of these mortgage-backed securities is limited by the provisions of the Investment Company Act.

In satisfying the 55% requirement under the Investment Company Act, we treat as qualifying interests mortgage-backed securities issued with respect to an underlying pool as to which we hold all issued certificates. If the SEC or its staff adopts a contrary interpretation of such treatment, we could be required to sell a substantial amount of our mortgage-backed securities under potentially adverse market conditions. Further, in our attempts to ensure that we at all times qualify for the exemption under the Investment Company Act, we might be precluded from acquiring mortgage-backed securities if their yield is higher than the yield on mortgage-backed securities that could be purchased in a manner consistent with the exemption. These factors may lower or eliminate our net income.

Misplaced reliance on legal opinions or statements by issuers of mortgage-backed securities could result in a failure to comply with REIT income or assets tests.

When purchasing mortgage-backed securities, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents, for purposes of determining whether and to what extent those securities constitute REIT real estate assets for purposes of the REIT asset tests and produce income that qualifies under the REIT gross income tests. The inaccuracy of any such opinions or statements may adversely affect our REIT qualification and result in significant corporate-level tax.

One-action rules may harm the value of the underlying property.

Several states have laws that prohibit more than one action to enforce a mortgage obligation, and some courts have construed the term action broadly. In such jurisdictions, if the judicial action is not conducted according to law, there may be no other recourse in enforcing a mortgage obligation, thereby decreasing the value of the underlying property.

We may be harmed by changes in various laws and regulations.

Changes in the laws or regulations governing Seneca or its affiliates may impair Seneca s or its affiliates ability to perform services in accordance with the Management Agreement. Our business may be harmed by changes to the laws and regulations affecting our manager or us, including changes to securities laws and changes to the Internal Revenue Code applicable to the taxation of REITs. New legislation may be enacted into law or new interpretations, rulings or regulations could be adopted, any of which could harm us, our manager and our stockholders, potentially with retroactive effect.

Legislation was recently enacted that reduces the maximum tax rate of non-corporate taxpayers for capital gains (for taxable years ending on or after May 6, 2003 and before January 1, 2009) and for dividends (for taxable years beginning after December 31, 2002 and before January 1, 2009) to 15%. Generally, dividends paid by REITs are not eligible for the new 15%

federal income tax rate, with certain exceptions discussed at United States Federal Income Tax Considerations Taxation of Taxable United States Stockholders Distributions Generally in the prospectus accompanying this prospectus supplement. Although this legislation does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable treatment of regular corporate dividends could cause investors who are individuals to consider stocks of other corporations that pay dividends as more attractive relative to stocks of REITs. It is not possible to predict whether this change in perceived relative value will occur, or what the effect will be on the market price of our common stock.

In addition, legislation was recently introduced in the United States House of Representatives and the United States Senate that would amend certain rules relating to REITs. Among other changes, the proposed legislation would provide the Internal Revenue Service with the ability to impose monetary penalties, rather than a loss of REIT status, for reasonable cause violations of certain tests relating to REIT qualification, and would change the formula for calculating the tax imposed for certain violations of the income tests discussed at United States Federal Income Tax Considerations Requirements for Qualification as a REIT Income Tests in the prospectus accompanying this prospectus supplement. In general, the changes would apply to taxable years beginning after the date the legislation is enacted. As of the date hereof, it is not possible to predict with any certainty whether the proposed legislation will be enacted in its current form.

We may incur excess inclusion income that would increase the tax liability of our stockholders.

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Internal Revenue Code. If we realize excess inclusion income and allocate it to stockholders, this income cannot be offset by net operating losses. If the stockholder is a tax-exempt entity, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Internal Revenue Code. If the stockholder is foreign, it would be subject to U.S. federal income tax withholding on this income without reduction pursuant to any otherwise applicable income-tax treaty.

Excess inclusion income could result if we held a residual interest in a real estate mortgage investment conduit, or REMIC. Excess inclusion income also would be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage-backed securities securing those debt obligations. We generally structure our borrowing arrangements in a manner designed to avoid generating significant amounts of excess inclusion income. We do, however, enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. The IRS may determine that these borrowings give rise to excess inclusion income that should be allocated among stockholders. Furthermore, some types of tax-exempt entities, including voluntary employee benefit associations and entities that have borrowed funds to acquire their shares of our common stock, may be required to treat a portion of or all of the dividends they may receive from us as unrelated business taxable income. Finally, we may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments.

Risks Related to this Offering

We have not established a minimum distribution payment level and we cannot assure you of our ability to make distributions to our stockholders in the future.

We intend to make quarterly distributions to our stockholders in amounts such that we distribute all or substantially all of our taxable income in each year, subject to certain adjustments. This, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. We have not established a minimum distribution payment level and our ability to make distributions might be harmed by the risk factors described in this prospectus supplement. All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of directors may deem relevant from time to time. We cannot assure you that we will have the ability to make distributions to our stockholders in the future.

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Restrictions on ownership of a controlling percentage of our capital stock might limit your opportunity to receive a premium on our stock.

For the purpose of preserving our REIT qualification and for other reasons, our charter prohibits direct or constructive ownership by any person of more than 9.8% of the lesser of the total number or value of the outstanding shares of our common stock or more than 9.8% of the outstanding shares of our preferred stock. The constructive ownership rules in our charter are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 9.8% of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 9.8% of the outstanding stock, and thus be subject to the ownership limit in our charter. Any attempt to own or transfer shares of our common or preferred stock in excess of the ownership limit without the consent of our board of directors shall be void, and will result in the shares being transferred by operation of law to a charitable trust. These provisions might inhibit market activity and the resulting opportunity for our stockholders to receive a premium for their shares that might otherwise exist if any person were to attempt to assemble a block of shares of our stock in excess of the number of shares permitted under our charter and which may be in the best interests of our stockholders.

Certain provisions of Maryland law and our charter and bylaws could hinder, delay or prevent a change in control of our company.

Certain provisions of Maryland law, our charter and our bylaws have the effect of discouraging, delaying or preventing transactions that involve an actual or threatened change in control of our company. These provisions include the following:

Classified Board of Directors. Our board of directors is divided into three classes with staggered terms of office of three years each. The classification and staggered terms of office of our directors make it more difficult for a third party to gain control of our board of directors. At least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of the board of directors.

Removal of Directors. Under our charter, subject to the rights of one or more classes or series of preferred stock to elect one or more directors, a director may be removed only for cause and only by the affirmative vote of at least two-thirds of all votes entitled to be cast by our stockholders generally in the election of directors.

Number of Directors, Board Vacancies, Term of Office. Under certain amendments to our bylaws which will become effective at such time as a class of our equity securities is registered under the Securities Exchange Act of 1934, as amended, or the Exchange Act, (which will occur upon completion of our IPO), we have elected to be subject to certain provisions of Maryland law which vest in the board of directors the exclusive right to determine the number of directors and the exclusive right, by the affirmative vote of a majority of the remaining directors, to fill vacancies on the board even if the remaining directors do not constitute a quorum. These provisions of Maryland law, which are applicable even if other provisions of Maryland law or the charter or bylaws provide to the contrary, also provide that any director elected to fill a vacancy shall hold office for the remainder of the full term of the class of directors in which the vacancy occurred, rather than the next annual meeting of stockholders as would otherwise be the case, and until his or her successor is elected and qualifies.

Limitation on Stockholder-Requested Special Meetings. Our bylaws provide that our stockholders have the right to call a special meeting only upon the written request of stockholders entitled to cast not less than a majority of all the votes entitled to be cast by the stockholders at such meeting.

Advance Notice Provisions for Stockholder Nominations and Proposals. Our bylaws require advance written notice for stockholders to nominate persons for election as directors at, or to bring other business before, any meeting of stockholders. This bylaw provision limits the ability of stockholders to make nominations of persons for election as directors or to introduce other proposals unless we are notified in a timely manner prior to the meeting.

Exclusive Authority of our Board to Amend the Bylaws. Our bylaws provide that our board of directors has the exclusive power to adopt, alter or repeal any provision of the bylaws or to make new bylaws. Thus, our stockholders may not effect any changes to our bylaws.

Preferred Stock. Under our charter, our board of directors has authority to issue preferred stock from time to time in one or more series and to establish the terms, preferences and rights of any such series of preferred stock, all without approval of our stockholders.

Duties of Directors with Respect to Unsolicited Takeovers. Maryland law provides protection for Maryland corporations against unsolicited takeovers by limiting, among other things, the duties of the directors in unsolicited takeover situations. The duties of directors of Maryland corporations do not require them to (1) accept, recommend or respond to any proposal by a person seeking to acquire control of the corporation, (2) authorize the corporation to redeem any rights

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under, or modify or render inapplicable, any stockholders rights plan, (3) make a determination under the Maryland Business Combination Act or the Maryland Control Share Acquisition Act, or (4) act or fail to act solely because of the effect of the act or failure to act may have on an acquisition or potential acquisition of control of the corporation or the amount or type of consideration that may be offered or paid to the stockholders in an acquisition. Moreover, under Maryland law the act of the directors of a Maryland corporation relating to or affecting an acquisition or potential acquisition of control is not subject to any higher duty or greater scrutiny than is applied to any other act of a director. Maryland law also contains a statutory presumption that an act of a director of a Maryland corporation satisfies the applicable standards of conduct for directors under Maryland law.

Ownership Limit. In order to preserve our status as a REIT under the Internal Revenue Code, our charter generally permits any single stockholder, or any group of affiliated stockholders, from beneficially owning more than 9.8% of our outstanding common or preferred stock unless our board of directors waives or modifies this ownership limit.

Maryland Business Combination Act. The Maryland Business Combination Act provides that unless exempted, a Maryland corporation may not engage in business combinations, including mergers, dispositions of 10% or more of its assets, issuance of shares of stock and other specified transactions, with an interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder became an interested stockholder, and thereafter unless specified criteria are met. An interested stockholder is generally a person owning or controlling, directly or indirectly, 10% or more of the voting power of the outstanding stock of a Maryland corporation. Our board of directors has adopted a resolution exempting our company from this statute. However, our board of directors may repeal or modify this resolution in the future, in which case the provisions of the Maryland Business Combination Act will be applicable to business combinations between our company and other persons.

Maryland Control Share Acquisition Act. Maryland law provides that control shares of a corporation acquired in a control share acquisition shall have no voting rights except to the extent approved by a vote of two-thirds of the votes eligible to be cast on the matter under the Maryland Control Share Acquisition Act. Control shares means shares of stock that, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of the voting power: one-tenth or more but less than one-third, one-third or more but less than a majority or a majority or more of all voting power. A control share acquisition means the acquisition of control shares, subject to certain exceptions. If voting rights of control shares acquired in a control share acquisition are not approved at a stockholders meeting, then subject to certain conditions and limitations, the issuer may redeem any or all of the control shares for fair value. If voting rights of such control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares of stock entitled to vote, all other stockholders may exercise appraisal rights. Our bylaws contain a provision exempting acquisitions of our shares from the Maryland Control Share Acquisition Act. However, our board of directors may amend our bylaws in the future to repeal or modify this exemption, in which case any control shares of our company acquired in a control share acquisition will be subject to the Maryland Control Share Acquisition Act.

Future offerings of debt securities, which would be senior to our common stock upon liquidation, or equity securities, which would dilute our existing stockholders and may be senior to our common stock for the purposes of distributions, may harm the value of our common stock.

In the future, we may attempt to increase our capital resources by making additional offerings of debt or equity securities, including commercial paper, medium-term notes, senior or subordinated notes and classes of preferred stock or common stock. Upon the liquidation of our company, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets prior to the holders of our common stock. Additional equity offerings by us may dilute the holdings of our existing stockholders or reduce the value of our common stock, or both. Our preferred stock, if issued, would have a preference on distributions that could limit our ability to make distributions to the holders of our common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our stockholders bear the risk of our future offerings reducing the market price of our common stock and diluting their stock holdings in us.

A regular trading market for our common stock might not develop, which would harm the liquidity and value of our common stock.

Our common stock is listed on the New York Stock Exchange under the symbol LUM. However, we cannot assure you that regular trading of our common stock will develop on that exchange or elsewhere or, if developed, that any such market will be sustained. Accordingly, we cannot assure you of:

the likelihood that a regular market for our common stock will develop;

the liquidity of any such market;

- the ability of our stockholders to sell their shares of our common stock; or
- the prices that our stockholders may obtain for their shares of our common stock.

The market price and trading volume of our common stock may be volatile.

Even if an active trading market develops for our common stock after this offering, the market price of our common stock may be highly volatile and be subject to wide fluctuations. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. If the market price of our common stock declines significantly, you may be unable to resell your shares at or above your purchase price. We cannot assure you that the market price of our common stock will not fluctuate or decline significantly in the future. Some of the factors that could negatively affect our stock price or result in fluctuations in the price or trading volume of our common stock include:

- actual or anticipated variations in our quarterly operating results or distributions;
- changes in our funds from operations or earnings estimates or publication of research reports about us or the real estate industry, although there can be no assurance that any research reports about us will be published;
- increases in market interest rates that lead purchasers of our shares to demand a higher yield;
- changes in market valuations of similar companies;
- adverse market reaction to any increased indebtedness we incur in the future;
- additions or departures of key management personnel;
- actions by institutional stockholders;
- speculation in the press or investment community; and
- general market and economic conditions.

Broad market fluctuations could harm the market price of our common stock.

The stock market has experienced extreme price and volume fluctuations that have affected the market price of many companies in industries similar or related to ours and that have been unrelated to these companies operating performances. These broad market fluctuations could reduce the market price of our common stock. Furthermore, our operating results and prospects may be below the expectations of public market analysts and investors or may be lower than those of companies with comparable market capitalizations, which could harm the market price of our common stock.

Shares of our common stock eligible for future sale may harm our stock price.

We cannot predict the effect, if any, of future sales of shares of our common stock, or the availability of shares for future sales, on the market price of our common stock. Sales of substantial amounts of these shares of common stock, or the perception that these sales could occur, may harm prevailing market prices for our common stock. As of March 1, 2004, there are:

- 24,841,146 shares of outstanding common stock;

- outstanding options to purchase 55,000 shares of our common stock at a weighted average exercise price of $14.82 per share; and

- an additional 943,505 shares of our common stock available for future awards under our stock incentive plans.

A total of 943,505 shares of our common stock, or 1% of our current total authorized shares, are reserved for future awards and grants under our stock incentive plans. We recently filed a registration statement on Form S-8 under the Securities Act covering the 1.0 million shares of our common stock reserved for issuance under the 2003 Stock Incentive Plan and/or subject to outstanding options under that stock incentive plan. Shares of our common stock issued upon exercise of options under the Form S-8 will be available for sale in the public market, subject to Rule 144 volume limitations applicable to affiliates and subject to the contractual restrictions described above.

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We recently issued 13,110,000 shares of common stock in our initial public offering. All of those shares are eligible for immediate resale by their holders. Similarly, all of the shares sold, from time to time, in this offering will be eligible for immediate resale by their holders.

If any or all of the above holders sell a large number of securities in the public market, the sale could reduce the market price of our common stock and could impede our ability to raise future capital through a sale of additional equity securities.

Changes in yields may harm the market price of our stock.

Our earnings are derived primarily from the expected positive spread between the yield on our assets and the cost of our borrowings. This spread will not necessarily be larger in high interest rate environments than in low interest rate environments and may also be negative. In addition, during periods of high interest rates, our net income, and therefore the amount of any distributions on our common stock, might be less attractive compared to alternative investments of equal or lower risk. Each of these factors could harm the market price of our common stock.

Terrorist attacks and other acts of violence or war may affect any market for our common stock, the industry in which we operate, our operations and our profitability.

Terrorist attacks may harm our results of operations and your investment. We cannot assure you that there will not be further terrorist attacks against the United States or U.S. businesses. These attacks or armed conflicts may impact the property underlying our mortgage-backed securities directly or indirectly, by undermining economic conditions in the United States. Losses resulting from terrorist events are generally uninsurable.

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DILUTION

Our net tangible book value as of December 31, 2003 was approximately $282.5 million, or $11.38 per share of our common stock. If you invest in our common stock, your interest will be diluted to the extent of the difference between the price you pay per share of our common stock and the net tangible book value per share of our common stock at the time of your purchase. Net tangible book value per share is calculated by subtracting our total liabilities from our total tangible assets, which is total assets less intangible assets, and dividing this amount by the number of shares of our common stock issued and outstanding. The sale of shares of common stock in this offering by the selling stockholders will not affect our net tangible book value because we will not receive any proceeds from their sale of our common stock. Based on our net tangible book value as of December 31, 2003, investors in this offering will experience immediate and substantial dilution to the extent that their purchase price per share exceeds $11.38. The following table illustrates this per share dilution based on an assumed purchase price of $15.02 per share, which was the February 27, 2004 closing price of our common stock on the NYSE:

Assumed purchase price per share		$ 15.02
Net tangible book value per share as of December 31, 2003	$ 11.38	
Increase per share attributable to new investors	0.00	
Net tangible book value per share		11.38
Dilution per share to new investors		$ 3.64

The foregoing discussion and table are based upon 24,814,000 shares actually issued and outstanding as of December 31, 2003. As of that date, there were also 55,000 options outstanding at a weighted-average exercise price of $14.82 per share and there were a total of 945,000 shares available for future awards under our stock incentive plans. Subsequent to December 31, 2003 we issued the following shares and options:

- we issued 25,651 shares of our common stock issued to Seneca as the equity component of its management fee for the fourth quarter of 2003;
- we issued 1,283 shares of our common stock issued to Mr. Zyda under our 2003 Stock Incentive Plan as the equity component of his contractual fourth quarter 2003 incentive bonus; and
- we issued 212 shares of our common stock to our controller under our 2003 Stock Incentive Plan as an incentive bonus.

BUSINESS

The Company

Background

We were formed in April 2003 to invest primarily in U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities, which we acquire in the secondary market. Our strategy is to acquire mortgage-related assets, finance these purchases in the capital markets and use leverage in order to provide an attractive return on stockholders equity. Through this strategy, we seek to earn income, which is generated from the spread between the yield on our earning assets and our costs, including the interest cost of the funds we borrow.

We commenced operations on June 11, 2003, following the completion of a private placement of our common stock, in which we raised net proceeds of approximately $159.7 million. On December 18, 2003, we completed the initial public offering of our shares of common stock and began trading on the New York Stock Exchange, or NYSE, under the trading symbol LUM on December 19, 2003. The initial public offering raised approximately $170.4 million in gross proceeds. The net proceeds from this offering were received in late December and substantially all of the net offering proceeds had been used to purchase mortgage-backed securities as of December 31, 2003. However, at December 31, 2003, we had not fully levered our portfolio to within our target range of eight to 12 times the amount of our equity. As a result, the total amount of mortgage-backed securities and repurchase agreement liabilities as of December 31, 2003 were lower than they will be once our portfolio is fully levered through additional repurchase agreement liabilities and related mortgage-backed security purchases.

We are externally managed and advised by Seneca Capital Management LLC, or Seneca, pursuant to a management agreement, or the Management Agreement.

We expect to qualify and intend to make an election to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, and as such will routinely distribute substantially all of the income generated from our operations to our stockholders. As long as we retain our REIT status, we generally will not be subject to U.S. federal or state taxes on our income to the extent that we distribute our net income to our stockholders.

Assets

We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. Adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis. Hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter reset periodically in a manner similar to adjustable-rate mortgage-backed securities. See Note 3 to the financial statements for further discussion.

We have acquired and will seek to acquire additional assets that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments. We expect that all of the mortgage-backed securities that we acquire will be agency-backed or have AAA credit ratings from at least one nationally-recognized statistical rating agency, and most of the securities will be hybrid adjustable-rate mortgage-backed securities.

We review the credit risk associated with each potential investment and may diversify our portfolio to avoid undue geographic, insurer, industry and other types of concentrations. By maintaining a large percentage of our assets in high quality and highly-rated assets, many of which are guaranteed under limited circumstances as to payment of a limited amount of principal and interest by federal agencies or federally chartered entities such as Fannie Mae, Freddie Mac or Ginnie Mae, we believe we can mitigate our exposure to losses from credit risk.

We have financed our acquisition of mortgage-backed securities by investing our equity and by borrowing at short-term rates under repurchase agreements. We intend to continue to finance our acquisitions in this manner.

Borrowings

We have established 17 borrowing arrangements with various investment banking firms and other lenders, 12 of which were in use on December 31, 2003. These borrowing arrangements facilitated our purchase of our initial portfolio of securities and provided us with sufficient borrowing capacity to fully leverage the net proceeds of our initial public offering. The repurchase agreements were secured by mortgage-backed securities. We intend to seek to renew repurchase agreements as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements. See Note 4 to the financial statements for further discussion.

We generally seek to borrow between eight and 12 times the amount of our equity. We actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the adjustment periods and the selection of indices on our mortgage-backed securities in order to manage our liquidity and interest rate related risks.

Hedging

We may also choose to engage in various hedging activities designed to match more closely the terms of our assets and liabilities. At December 31, 2003, we were engaged in short sales of Eurodollar futures contracts as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements. The value of these futures contracts is marked-to-market daily in our margin account with the custodian. Based upon the daily market value of these futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts. See Note 12 to the financial statements for further discussion.

Distributions

On November 17, 2003, we paid a cash distribution of $0.50 per share to our stockholders of record on October 21, 2003. On January 28, 2004, we paid a cash distribution of $0.45 per share to our stockholders of record on December 11, 2003. Both of these distributions are taxable dividends, and neither of these distributions are considered return of capital. The distributions were funded with cash flow from our ongoing operations, including principal payments and interest payments on our mortgage-backed securities.

Business Strategy

Our Operating Policies and Programs

Our board of directors has established the following four primary operating policies to implement our business strategies:

- asset acquisition policy;
- capital/liquidity and leverage policies;
- credit risk management policy; and
- asset/liability management policy.

Asset Acquisition Policy

Our asset acquisition policy provides guidelines for acquiring investments in order to maintain compliance with our overall investment strategy. In particular, we acquire a portfolio of investments that can be grouped into specific categories. Each category and our respective investment guidelines are as follows:

Category I At least 75% of our total assets will generally be residential mortgage-related securities and short-term investments. Assets in this category are rated within one of the two highest rating categories by at least one nationally-recognized statistical rating organization, or will be obligations guaranteed by federal agencies or federally chartered agencies, such as Fannie Mae, Freddie Mac or Ginnie Mae.

Category II At least 90% of our total assets will consist of Category I investments plus mortgage-related securities that are rated at least investment grade by at least one nationally-recognized statistical rating organization.

Category III No more than 10% of our total assets may be of a type not meeting any of the above criteria. Among the types of assets generally assigned to this category are mortgage-related securities rated below investment grade and leveraged mortgage derivative securities, or shares of other REITs, or other investments.

We expect to acquire only those mortgage-related assets which we believe our manager has the necessary expertise to evaluate and manage, which we can readily finance, and which are consistent with our overall investment strategy and our asset acquisition policy. Generally, we expect to hold our mortgage-backed securities until maturity. Therefore, we generally do not seek to acquire assets with investment returns that are attractive only in a limited range of scenarios. Future interest rates and mortgage prepayment rates are very difficult to predict and, as a result, we seek to acquire mortgage-backed securities which we believe provide acceptable returns over a broad range of interest rate and prepayment scenarios.

We expect most of our acquisitions to consist of adjustable-rate mortgage-backed securities, hybrid adjustable-rate mortgage-backed securities and fixed-rate mortgage-backed securities. We anticipate that our investments in fixed-rate mortgage-backed securities will be focused in shorter-term mortgages, including balloon mortgages. We may, however, purchase longer-term fixed-rate mortgage-backed securities if we view the potential net returns as attractive or if the acquisition of such assets serves to reduce or diversify the overall risk profile of our portfolio.

Capital/Liquidity and Leverage Policies

We employ a leverage strategy to increase our investment assets by borrowing against existing mortgage-backed securities and using the proceeds to acquire additional mortgage-backed securities. We generally seek to borrow between eight to 12 times the amount of our equity, although our borrowings may vary from time to time depending on market conditions and other factors deemed relevant by our manager and our board of directors. We believe that this leaves an adequate capital base to protect against interest rate environments in which our borrowing costs might exceed our interest income from mortgage-backed securities.

Depending on the different cost of borrowing funds at different maturities, we expect to vary the maturities of our borrowed funds to attempt to produce lower borrowing costs. In general, our borrowings are short-term. We actively manage, on an aggregate basis, both the interest-rate indices and interest-rate adjustment periods of our borrowings against the interest-rate indices and interest-rate adjustment periods related to our mortgage-backed securities.

We expect to continue to finance our mortgage-backed securities primarily at short-term borrowing rates through repurchase agreements and, to a lesser extent, our equity capital. We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will use the collateral immediately for borrowing under a new repurchase agreement. In the future we may also employ borrowings under lines of credit, term loans and other collateralized financings that we may establish with approved institutional lenders and we may employ long-term borrowings.

We have established 17 borrowing arrangements with various investment banking firms and other lenders. A repurchase agreement, although structured as a sale and repurchase obligation, acts as a financing under which we effectively pledge our mortgage-backed securities as collateral to secure a short-term loan. Generally, the other party to the agreement makes the loan in an amount equal to a percentage of the market value of the pledged collateral. At the maturity of the repurchase agreement, we are required to repay the loan and correspondingly receive back our collateral. While used as collateral, the mortgage-backed securities continue to pay principal and interest to us. In the event of our insolvency or bankruptcy, certain repurchase agreements may qualify for special treatment under the U.S. Federal Bankruptcy Code, the effect of which, among other things, would be to allow the creditor under the agreement to avoid the automatic stay provisions of the U.S. Federal Bankruptcy Code and to foreclose on the collateral agreement without delay. In the event of the insolvency or bankruptcy of the lender during the term of a repurchase agreement, the lender may be permitted, under applicable insolvency laws, to repudiate the contract, and our claim against the lender for damages may be treated simply as an unsecured creditor. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970, or an insured depository institution subject to the Federal Deposit Insurance Act, our ability to exercise our rights to recover our securities under a repurchase agreement or to be compensated for any damages resulting from the lender s insolvency may be further limited by those statutes. These claims would be subject to significant delay and, if and when received, may be substantially less than the damages we actually incur. As a result, we expect to enter into collateralized borrowings only with institutions that we believe are financially sound and which are rated investment grade by at least one nationally-recognized statistical rating organization.

Substantially all of our borrowing agreements require us to deposit additional collateral in the event the market value of existing collateral declines, which may require us to sell assets to reduce our borrowings. We have designed our liquidity management policy to maintain an adequate capital base sufficient to provide required liquidity to respond to the effects under our borrowing arrangements of interest rate movements and changes in the market value of our mortgage-backed securities, as described above. However, a major disruption in the repurchase or other market that we rely on for short-term borrowings would harm our results of operations unless we were able to arrange alternative sources of financing on comparable terms.

Credit Risk Management Policy

We review credit risk associated with each of our potential investments. In addition, we may diversify our portfolio of mortgage-backed securities to avoid undue geographic, insurer, industry and certain other types of concentration risk. We may reduce risk from sellers and servicers by obtaining representations and warranties. Our manager monitors the overall portfolio risk in order to determine appropriate levels of provision for losses we may experience.

We generally determine, at the time of purchase, whether or not a mortgage-related asset complies with our credit risk management policy guidelines, based upon the most recent information utilized by us. Such compliance is not expected to be affected by events subsequent to such purchase, such as changes in characterization, value or rating of any specific mortgage-related assets or economic conditions or events generally affecting any mortgage-related assets of the type held by us.

Asset/Liability Management Policy

Interest Rate Risk Management. To the extent consistent with our election to qualify as a REIT, we follow an interest rate risk management program intended to protect our portfolio of mortgage-backed securities and related debt against the effects of major interest rate changes. Specifically, our interest rate management program is formulated with the intent to offset, to some extent, the potential adverse effects resulting from rate adjustment limitations on our mortgage-backed securities and the differences between interest rate adjustment indices and interest rate adjustment periods of our adjustable-rate mortgage-backed securities and related borrowings.

Our interest rate risk management program encompasses a number of procedures, including the following:

- monitoring and adjusting, if necessary, the interest rate sensitivity of our mortgage-backed securities compared with the interest rate sensitivities of our borrowings;
- attempting to structure our borrowing agreements to have a range of different maturities and interest rate adjustment periods (although substantially all will be less than one year); and
- actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of the mortgages underlying our mortgage-backed securities compared to the interest rate indices and adjustment periods of our borrowings.

As a result, we expect to be able to adjust the average maturity/adjustment period of our borrowings on an ongoing basis by changing the mix of maturities and interest rate adjustment periods as borrowings mature or are renewed. Through the use of these procedures, we attempt to reduce the risk of differences between interest rate adjustment periods of the mortgages underlying our adjustable-rate mortgage-backed securities and our related borrowings.

It is generally our intention to manage the assets in our portfolio with regard to risk characteristics such as duration, in order to carefully limit the overall interest rate risk of the portfolio. On occasion, we may alter the overall duration in order to better protect the portfolio in order to protect shareholder value. Similarly, it is our intention to manage the duration of our liabilities. Generally, we will seek to reduce the gap between the duration of our assets and our liabilities to a level which is consistent with protection of the portfolio during volatile interest rate environments. The means by which we will accomplish this objective will vary over time, and may include the use of hedging instruments and the alteration of the duration of the asset and/or the liability side of our balance sheet through asset purchases or sales and through the assumption or the retirement of repurchase agreements of varying maturities or the structuring of other financing arrangements.

Depending on market conditions and the cost of the transactions, we may conduct hedging activities in connection with our portfolio management. When we engage in hedging activities, we intend to do so in a manner consistent with our election to qualify as a REIT. The goal of any hedging strategy we adopt will be to lessen the effects of interest rate changes and to enable us to earn net interest income in periods of generally rising, as well as declining or static, interest rates. Specifically, if we implement a hedging program, it would likely be formulated with the intent to offset some of the potential adverse effects of changes in interest rate levels relative to the interest rates on the mortgage-backed securities held in our investment portfolio, as well as differences between the interest rate adjustment indices and maturity or reset periods related to our mortgage-backed securities and our borrowings.

Under the REIT rules of the Internal Revenue Code, some hedging activities produce income which is not qualifying income for purposes of the REIT gross income tests or create assets which are not qualifying assets for purposes of the REIT assets test. As a result, we may have to terminate certain hedging activities before the benefits of such activities are realized. In the case of excess hedging income, we would be required to pay a penalty tax for failure to satisfy certain REIT income tests under the Internal Revenue Code if the excess is due to reasonable cause and not willful neglect. In the case of having excess value in relation to mortgage-related assets, the penalty would result in our disqualification as a REIT. In addition, asset/liability management involves

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transaction costs that increase dramatically as the period covered by hedging protection increases and that may increase during periods of fluctuating interest rates.

Prepayment Risk Management. We also seek to lessen the effects of prepayment of mortgage loans underlying our securities at a faster or slower rate than anticipated. We expect to accomplish this by using a variety of techniques which include, without limitation, structuring a diversified portfolio with a variety of prepayment characteristics, investing in mortgage-backed securities based on mortgage loans with prepayment prohibitions and penalties, investing in certain mortgage security structures that have prepayment protections, and purchasing mortgage-backed securities at a premium and at a discount. We intend to monitor prepayment risk through the periodic review of the impact of a variety of prepayment scenarios on our revenues, net earnings, distributions, cash flow and net balance sheet market value.

We believe that we have developed cost-effective asset/liability management policies to mitigate interest rate and prepayment risks. We continually monitor our risk management strategies as market conditions change. However, no strategy can completely insulate us from interest rate and prepayment risks. Further, as noted above, certain of the U.S. federal income tax requirements that we must satisfy to qualify as a REIT limit our ability to fully hedge our interest rate and prepayment risks. Therefore, we could be prevented from effectively hedging our interest rate and prepayment risks.

Description of Mortgage-Related Assets

Mortgage-Backed Securities

Pass-Through Certificates. We expect principally to invest in pass-through certificates, which are securities representing interests in pools of mortgage loans secured by residential real property in which payments of both interest and principal on the securities are generally made monthly. In effect, these securities pass through the monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer or guarantor of the securities. Pass-through certificates can be divided into various categories based on the characteristics of the underlying mortgages, such as the term or whether the interest rate is fixed or variable.

A key feature of most mortgage loans is the ability of the borrower to repay principal earlier than scheduled. This is called a prepayment. Prepayments can arise due to sale of the underlying property, refinancing, foreclosure, or other events. Prepayments result in a return of principal to pass-through certificate holders. This may result in a lower or higher rate of return upon reinvestment of principal. This is generally referred to as prepayment uncertainty. If a security purchased at a premium pre-pays at a higher than expected rate, then the value of the premium would be eroded at a faster than expected rate. Similarly, if a discount mortgage pre-pays at a lower than expected rate, the amortization towards par would be accumulated at a slower than expected rate. The possibility of these undesirable effects is sometimes referred to as prepayment risk.

In general, but not always, declining interest rates tend to increase prepayments, and rising interest rates tend to slow prepayments. Like other fixed-income securities, when interest rates rise, the value of mortgage-backed securities generally decline. The rate of prepayments on underlying mortgages will affect the price and volatility of mortgage-backed securities and may have the effect of shortening or extending the effective maturity of the security beyond what was anticipated at the time of purchase. If interest rates rise, our holdings of mortgage-backed securities may experience reduced returns if the borrowers of the underlying mortgages pay off their mortgages later than anticipated. This is generally referred to as extension risk.

Payment of limited amounts of principal and interest on some mortgage pass-through securities, although not the market value of the securities themselves, may be guaranteed by the full faith and credit of the federal government, including securities backed by Ginnie Mae, or by agencies or instrumentalities of the federal government, including Fannie Mae or Freddie Mac. Mortgage-backed securities created by non-governmental issuers, including commercial banks, savings and loan institutions, private mortgage insurance companies, mortgage bankers and other secondary market issuers, may be supported by various forms of insurance or guarantees, including individual loan, title, pool and hazard insurance and letters of credit, which may be issued by governmental entities, private insurers or the mortgage poolers.

The mortgage loans underlying pass-through certificates can generally be classified in the following four categories:

Adjustable-Rate Mortgages. Adjustable-rate mortgages, or ARMs, are those for which the borrower pays an interest rate that varies over the term of the loan. The interest rate usually resets based on market interest rates, although the adjustment of such an interest rate may be subject to certain limitations. Traditionally, interest rate resets occur at regular set intervals (for example, once per year). We will refer to such ARMs as traditional ARMs. Because the interest rates on ARMs fluctuate based on market conditions, ARMs tend to have interest rates that do not deviate from current market rates by a large amount. This in turn can mean that ARMs have less price sensitivity to interest rates. This may be attractive to some mortgage investors.

Fixed-Rate Mortgages. Fixed-rate mortgages are those where the borrower pays an interest rate that is constant throughout the term of the loan. Traditionally, most fixed-rate mortgages have an original term of 30 years. However, shorter terms (also referred to as final maturity dates) have become common in recent years. Because the interest rate on the loan never changes, even when market interest rates change, over time there can be a divergence between the interest rate on the loan and current market interest rates. This in turn can make a fixed-rate mortgage s price sensitive to market fluctuations in interest rates. In general, the longer the remaining term on the mortgage loan, the greater the price sensitivity. One way to attempt to lower the price sensitivity of a portfolio of fixed-rate mortgages is to buy those with shorter remaining terms or maturities.

Hybrid Adjustable-Rate Mortgages. A recent development in the mortgage market has been the popularity of ARMs that do not reset at regular intervals. Many of these ARMs have a fixed-rate for the first few years of the loan typically three, five, seven or 10 years and thereafter reset periodically like a traditional ARM. Effectively such mortgages are hybrids, combining the features of a pure fixed-rate mortgage and a traditional ARM. Hybrid ARMs have a price sensitivity to interest rates similar to that of a fixed-rate mortgage during the period when the interest rate is fixed and similar to that of an ARM when the interest rate is in its periodic reset stage. However, because many hybrid ARMs are structured with a relatively short initial time span during which the interest rate is fixed, even during that segment of its existence, the price sensitivity may be low. The ability of hybrid ARMs to exhibit low price sensitivity to interest rates can be attractive to some mortgage investors.

Balloon Maturity Mortgages. Balloon maturity mortgages are a type of fixed-rate mortgage. Thus, they have a static interest rate for the life of the loan. However the term of the loan is usually quite short and is less than the amortization schedule of the loan. Typically, this term or maturity is less than seven years. When the mortgage matures, the investor receives all of his principal back. This is effectively a price reset of the invested principal to par. As the balloon maturity mortgage approaches its maturity date, the price sensitivity of the mortgage declines. In fact, the price sensitivity for an agency balloon mortgage with a set maturity is actually lower than that for an agency hybrid ARM with the same time to interest rate reset. The ability of a balloon mortgage to have low price sensitivity to interest rates can be attractive for some mortgage investors.

Collateralized Mortgage Obligations. Collateralized mortgage obligations, or CMOs, are a type of mortgage-backed security. Interest and principal on a CMO are paid, in most cases, on a monthly basis. CMOs may be collateralized by whole mortgage loans, but are more typically collateralized by portfolios of mortgage pass-through securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. CMOs are structured into multiple classes, or tranches, with each class bearing a different stated maturity. Monthly payments of principal, including prepayments, are first returned to investors holding the shortest maturity class; investors holding the longer maturity classes receive principal only after the first class has been retired.

Generally, fixed-rate mortgages are used to collateralize CMOs. However, the CMO tranches need not all have fixed-rate coupons. Some CMO tranches have floating rate coupons that adjust based on market interest rates, subject to some limitations. Such tranches, often called CMO floaters, can have relatively low price sensitivity. As is the case with traditional ARMs, hybrid ARMs and balloons, this low price sensitivity may be attractive to some mortgage investors.

Mortgage Derivative Securities. Although we do not have any intention to do so in the near term, we may acquire mortgage derivative securities in an amount not to exceed 10% of our total assets. Mortgage derivative securities allow the holder to receive interest only, principal only, or interest and principal in amounts that are disproportionate to those payable on the underlying mortgage loans. Payments on mortgage derivative securities can be highly sensitive to the rate of prepayments on the underlying mortgage loans. In the event of faster or slower than anticipated prepayments on these mortgage loans, the rates of return on interests in mortgage derivative securities representing the right to receive interest only or a disproportionately large amount of interest, or interest only derivatives, would be likely to decline or increase, respectively. Conversely, the rates of return on mortgage derivative securities representing the right to receive principal only or a disproportionate amount of principal, or principal only derivatives, would be likely to increase or decrease in the event of faster or slower prepayment speeds, respectively.

We may also invest in inverse floaters, a class of CMOs with a coupon rate that resets in the opposite direction from the market rate of interest to which it is indexed, including LIBOR or the 11th District Cost of Funds Index, or COFI. Any rise in the index rate, which can be caused by an increase in interest rates, causes a drop in the coupon rate of an inverse floater while any drop in the index rate causes an increase in the coupon of an inverse floater. An inverse floater may behave like a leveraged security since its interest rate usually varies by a magnitude much greater than the magnitude of the index rate of interest. The leverage-like characteristics inherent in inverse floaters are associated with greater volatility in their market prices.

We may also invest in other mortgage derivative securities that may be developed in the future.

Subordinated Interests. We may also acquire subordinated interests, which are classes of mortgage-backed securities that are junior to other classes of the same series of mortgage-backed securities in the right to receive payments from the underlying mortgage loans. The subordination may be for all payment failures on the mortgage loans securing or underlying such series of mortgage securities. The subordination will not be limited to those resulting from particular types of risks, including those resulting from war, earthquake or flood, or the bankruptcy of a borrower. The subordination may be for the entire amount of the series of mortgage-related securities or may be limited in amount.

Mortgage Loans

We may acquire and accumulate mortgage loans (i.e., fixed-rate, ARMs, hybrid and balloon mortgage loans) as part of our investment strategy until a sufficient quantity has been accumulated for securitization into high-quality mortgage-backed securities in order to enhance their value and liquidity. Pursuant to our asset acquisition policies, the aggregate amount of any mortgage loans that we acquire and do not immediately securitize, together with our investments in other mortgage-related assets that are not Category I or Category II assets, will not constitute more than 10% of our total assets at any time. All mortgage loans, if any, will be acquired with the intention of securitizing them into high-credit quality mortgage securities. Despite our intentions, however, we may not be successful in securitizing these mortgage loans. To meet our investment criteria, mortgage loans acquired by us will generally conform to the underwriting guidelines established by Fannie Mae, Freddie Mac, Ginnie Mae or other credit insurers. Applicable banking laws generally require that an appraisal be obtained in connection with the original issuance of mortgage loans by the lending institution. We do not intend to obtain additional appraisals at the time of acquiring any mortgage loans.

Mortgage loans may be originated by or purchased from various suppliers of mortgage-related assets throughout the United States, including savings and loans associations, banks, mortgage bankers and other mortgage lenders. We may acquire mortgage loans directly from originators and from entities holding mortgage loans originated by others. Our board of directors has not established any limits upon the geographic concentration of mortgage loans that we may acquire. However, our asset acquisition policy will limit the amount and/or type of mortgage loans we may acquire.

Other Investments

We may acquire other investments that include equity and debt securities issued primarily by other mortgage-related finance companies, interests in mortgage-related collateralized bond obligations, other subordinated interests in pools of mortgage-related assets, commercial mortgage loans and securities, and residential mortgage loans other than high-credit quality mortgage loans. These investments are generally considered Category III investments under our asset acquisition policy and shall be limited to 10% of our total assets.

We also intend to operate in a manner that will not subject us to regulation under the Investment Company Act. Our board of directors has the authority to modify or waive our current operating policies and our strategies without prior notice to you and without stockholder approval.

Investment Strategy

Our strategy is to invest primarily in U.S. agency and other highly-rated single-family adjustable-rate and fixed-rate mortgage-backed securities. We acquire these investments in the secondary market and seek to acquire assets that will produce competitive returns after considering the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments. We do not construct our overall investment portfolio in order to express a directional expectation for interest rates or mortgage prepayment rates. Future interest rates and mortgage prepayment rates are very difficult to predict and, as a result, we seek to acquire mortgage-backed securities which we believe provide acceptable returns over a broad range of interest rate and prepayment scenarios. When evaluating the purchase of mortgage-backed securities, we analyze whether the purchase will permit us to continue to satisfy the minimum 55% portfolio whole-pool requirement, with which we must comply to maintain our REIT status. We also assess the relative value of the mortgage-backed security and how well it would fit into our existing portfolio of mortgage-backed securities. Many aspects of a mortgage-backed security, and the dynamic interaction of its characteristics with those of our portfolio, can influence our perception of what that security is worth and the amount of premium we would be willing to pay to own the specific security. The characteristics of each potential investment we analyze generally include, but are not limited to, the following:

origination year the underwriting year for the mortgages comprising the mortgage-backed security. This characteristic helps to determine how seasoned the mortgage-backed security is and can influence our expectations for the investment s future cash flows. In the current low interest rate environment, mortgages that were originated several years ago (when interest rates were higher) tend to have been refinanced. Those borrowers who did not refinance their homes during the period of lower interest rates may be relatively less likely (than more recent borrowers) to refinance during the remaining life of their mortgages. Therefore, the expected cash flows from a potential investment with an earlier origination year could exhibit less sensitivity to changes in interest rates.

originator the financial services entity that underwrites the mortgages comprising the mortgage-backed security. Originators do not have homogeneous underwriting standards. The particular underwriting standards utilized by an originator tend to influence the characteristics of the borrowers in its mortgage loan pools which, in turn, can influence the pool s prepayment rates and other cash flows. When analyzing a pool of mortgages, it can be useful to review the historical cash flows exhibited by the originator s prior mortgage loan pools. For example, we may limit the premium we would be willing to pay for a security if the originator has a history of early refinancings. The quality of the originator s underwriting standards and the terms it offers borrowers can also be important to our purchase decisions. These variables potentially include the originator s required loan documentation, FICO scores, loan-to-value ratios, prepayment penalties, cap rates, and assumability terms. Any of these variables might influence our expectations regarding the timing of cash flows from an originator s mortgage-backed securities and, thus, their attractiveness for our portfolio.

coupon the weighted-average mortgage coupon of the mortgage-backed security. Higher coupons are initially attractive because they can generate more interest income for us than lower-coupon mortgage-backed securities. However, the sustainability of cash flows from higher-coupon pools is less predictable because, all else being equal, higher-coupon mortgages have a greater probability of being refinanced than lower-coupon mortgages. We generally analyze a mortgage-backed security s coupon in comparison to current market rates to form an expectation regarding how sustainable the interest income from the investment will be.

margin the spread between an adjustable-rate mortgage s market index and the interest rate that the borrower must pay to service the mortgage. Similar to higher coupons, higher margins are attractive because they can generate more interest income for us than lower-margin mortgage-backed securities. However, higher-margin mortgage pools may be more prone to experience faster refinancing rates because high-margin borrowers are relatively more likely to find opportunities to refinance into mortgages with lower spreads to the index. As a result, the sustainability of the yield from an investment in a high-margin mortgage pool is less certain and the premium we would be willing to pay on such an investment, all else being equal, is less.

periodic cap the amount by which the interest rate on an adjustable-rate mortgage can adjust during a specified period, usually six or 12 months. In rapidly rising interest rate environments, higher periodic caps are more attractive because they reduce the risk of the adjustable-rate mortgage coupon not being able to reset fully upwards to the current market rate. Conversely, in rapidly falling interest rate environments, lower periodic caps increase the probability that the mortgage s coupon will reset to a level that remains above the current market rate.

lifetime cap the maximum interest rate that a specific adjustable-rate mortgage can have during its lifetime. The lifetime cap of a mortgage is often correlated with market interest rates at the time of origination. An adjustable-rate mortgage originated in a low interest rate environment frequently will have a lower lifetime cap than a comparably structured mortgage originated in a high interest rate environment. If interest rates rise sufficiently, an adjustable-rate mortgage with a lifetime cap can effectively behave like a fixed-rate mortgage because the coupon of the adjustable-rate mortgage cannot adjust above the lifetime cap, and will thus remain effectively fixed at that level until rates fall. Higher lifetime caps tend to make particularly structured hybrid or adjustable-rate mortgage pools more attractive investment candidates.

time-to-reset the number of months before the current coupon of the hybrid or adjustable-rate mortgage will reset. Time-to-reset is an important consideration as we structure the timing of interest rate adjustments on the mortgage-backed securities in our portfolio relative to changes in our borrowing costs.

loan-to-value the ratio between the original loan amount and the value of the collateral securing the mortgage loan. We consider this factor less important in a decision to purchase agency-backed mortgage securities but it can be an important factor when purchasing non-agency securities. This factor also influences the subordination levels required by the national rating agencies to receive AAA-rated status.

geographic dispersion the degree to which the properties underlying the pooled mortgage loans are geographically dispersed. We prefer greater geographic dispersion because we wish to limit our exposure to specific states or regions (which might be experiencing relatively greater economic difficulties) to create a more stable portfolio.

price and prepayment expectations the expected yield of the mortgage-backed security under various assumptions about future economic conditions. A mortgage-backed security s ultimate yield is determined by its price and its actual prepayment levels. We generally form expectations, based on the above factors, regarding how the mortgage pool s prepayment levels will change over time, including in response to possible changes in prevailing interest rates and other economic conditions, so as to determine whether its offered price creates a yield that is attractive and fits well with the expected structure of our portfolio and our borrowing costs under those scenarios.

We generally consider these factors when evaluating an investment s relative value and the impact it would likely have on our overall portfolio. We do not assign a particular weight to any factor because the relative importance of the various factors varies, depending upon the characteristics we seek for our portfolio and our borrowing cost structure.

We do not currently originate mortgage loans or provide other types of financing to the owners of real estate and we do not service any mortgage loans. However, in the future, we may elect to originate mortgage loans or other types of financing, and we may elect to service mortgage loans and other types of financing.

Financing Strategy

We expect to finance the acquisition of our mortgage-backed securities with short-term borrowings and term loans with a term of less than one year and, to a lesser extent, equity capital. After analyzing the then-applicable interest rate yield curves, we may finance with long-term borrowings from time to time. The amount of borrowing we employ depends on, among other factors, the amount of our equity capital. We expect to use leverage to attempt to increase potential returns to our stockholders. Pursuant to our capital and leverage policy, we seek to strike a balance between the under-utilization of leverage, which reduces potential returns to our stockholders, and the over-utilization of leverage, which increases risk by reducing our ability to meet our obligations to creditors during adverse market conditions.

We expect to borrow at short-term rates using repurchase agreements. Repurchase agreements are generally short-term in nature. We intend to actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the adjustment periods and the selection of indices on our mortgage-backed securities in order to limit our liquidity and interest rate related risks. We generally seek to diversify our exposure by entering into repurchase agreements with multiple lenders. In addition, we expect to enter into repurchase agreements only with institutions we believe are financially sound and which meet credit standards approved by our board of directors.

Industry Trends

We believe fundamental changes are occurring in the U.S. mortgage market, resulting in the shifting of investment capital and mortgage-related assets out of traditional lending and savings institutions and into new forms of mortgage banking and mortgage investment firms, including those that qualify as REITs under the Internal Revenue Code. We believe that traditional mortgage investment companies, such as banks, thrifts and insurance companies, provide less attractive investment structures for investing in mortgage-related assets because of the costs associated with regulation, infrastructure and corporate level taxation. As a REIT, we can generally pass through earnings to our stockholders without incurring an entity-level federal income tax, thereby allowing us to make higher distributions than institutions with similar investments that are subject to federal income tax on their earnings. Additionally, with the development of highly competitive national mortgage markets (which we believe is partly due to the expansion of government sponsored enterprises such as Fannie Mae, Freddie Mac and Ginnie Mae), local and regional mortgage originators have lost market share to more efficient mortgage originators who compete nationally. The growth of the secondary mortgage market, including new securitization techniques, has also resulted in financing structures that can be utilized efficiently to fund leveraged mortgage portfolios and better manage interest rate risk.

The U.S. residential mortgage market has experienced considerable growth over the past 11 years, with total outstanding U.S. residential mortgage debt growing from approximately $3.0 trillion in 1992 to approximately $7.1 trillion as of September 30, 2003, according to the Federal Reserve. According to the same source, the total amount of U.S. residential mortgage debt securitized into mortgage-backed securities has grown from approximately $1.4 trillion in 1992 to approximately $4.1 trillion as of September 30, 2003, approximately $3.3 trillion of which was agency-backed and therefore generally consistent with our investment guidelines. As of September 30, 2003, approximately $47.2 billion of the available mortgage-backed securities was held by REITs.

Competition

When we invest in mortgage-backed securities and other investment assets, we compete with a variety of institutional investors, including other REITs, insurance companies, mutual funds, hedge funds, pension funds, investment banking firms, banks and other financial institutions that invest in the same types of assets. Many of these investors have greater financial resources and access to lower costs of capital than we do. The existence of these competitive entities, as well as the possibility of additional entities forming in the future, may increase the competition for the acquisition of mortgage-backed securities, resulting in higher prices and lower yields on assets.

Website Access to our Periodic SEC Reports

The Internet address of our corporate website is *www.luminentcapital.com*. We make our periodic SEC reports (on Forms 10-K and 10-Q) and current reports (on Form 8-K), as well as the beneficial ownership reports filed by our directors, officers and 10% stockholders (on Forms 3, 4 and 5) available free of charge through our website as soon as reasonably practicable after they are filed electronically with the SEC. We may from time to time provide important disclosures to investors by posting them in the investor relations section of our website, as allowed by SEC rules. The information on our website is not a part of this Form 10-K.

Materials we file with the SEC may be read and copied at the SEC s Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet website at *www.sec.gov* that will contain our reports, proxy and information statements, and other information regarding our company that we will file electronically with the SEC.

Employees

Our day-to-day operations are externally managed and advised by our manager, Seneca Capital Management LLC. At December 31, 2003 we had two full-time employees. We employ a full-time chief financial officer, Christopher J. Zyda, whose primary responsibilities include monitoring Seneca s performance under our Management Agreement, as well as a full-time controller.

We do not employ any of our officers other than Mr. Zyda. Our other executive officers are employees and/or officers of Seneca Capital Management LLC and are compensated by Seneca Capital Management LLC.

Facilities

Our principal offices are located at 909 Montgomery Street, Suite 500, San Francisco, California 94133. We utilize approximately 1,500 square feet of space provided by our Manager.

Legal Proceedings

At December 31, 2003, there were no pending legal proceedings to which we were party or of which any of our properties were subject.

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SELECTED FINANCIAL DATA

The following summary financial data are derived from audited financial statements as of April 25, 2003 (inception), June 30, 2003 and December 31, 2003 and for the period from April 26, 2003 through June 30, 2003 and for the period from April 26, 2003 through December 31, 2003, and unaudited financial statements as of September 30, 2003 (as restated), for the period April 26, 2003 through September 30, 2003 (as restated), for the three months ended September 30, 2003 (as restated) and for the three months ended December 31, 2003. The selected financial data should be read in conjunction with the more detailed information contained in the financial statements and notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this prospectus supplement. See Note 10 to the financial statements in the prospectus accompanying this prospectus supplement for a discussion of the restatement of the financial information below.

(dollars in thousands, except share and per share amounts)	For the period April 26, 2003 through December 31, 2003	For the three months ended December 31, 2003	For the three months ended September 30, 2003 (as restated)	For the period April 26, 2003 through June 30, 2003
Statement of Operations Data:				
Revenues:				
Net interest income:				
Interest income	$ 22,654	$ 11,205	$ 10,777	$ 672
Interest expense	9,009	4,518	4,327	164
Net interest income	13,645	6,687	6,450	508
Losses on sales of mortgage-backed securities	(7,831)		(7,831)	
Expenses:				
Management fee expense to related party	901	418	398	85
Incentive fee expense to related party	980	367	613	
Salaries and benefits	99	59	41	
Professional services	477	130	123	224
Board of directors expense	117	56	39	22
Insurance expense	291	128	128	35
Custody expense	115	65	47	3
Other general and administrative expenses	73	60	10	2
Total expenses	3,053	1,283	1,399	371
Net income (loss)	$ 2,761	$ 5,404	$ (2,780)	$ 137

Basic and diluted earnings (loss) per share	$ 0.27	$ 0.40	$ (0.24)	$ 0.04
Weighted-average number of shares outstanding, basic	10,139,280	13,414,000	11,704,000	3,393,394
Weighted-average number of shares outstanding, diluted	10,139,811	13,414,260	11,704,000	3,393,394

(dollars in thousands, except per share amounts)	December 31, 2003	September 30, 2003 (as restated)	June 30, 2003	April 25, 2003 (inception)
Balance Sheet Data:				
Mortgage-backed securities available for sale, at fair value	$ 352,123	$ 108,886	$ 496,630	$
Mortgage-backed securities pledged as collateral, at fair value	1,809,822	1,496,209	1,217,326	
Total mortgage-backed securities, at fair value	2,161,945	1,605,095	1,713,956	
Total assets	2,179,340	1,831,082	1,719,447	1
Repurchase agreements and margin debt	1,728,973	1,472,875	1,154,939	
Unsettled security purchases	156,127	215,742	407,777	
Total liabilities	1,896,844	1,691,631	1,564,199	
Accumulated other comprehensive loss	(26,510)	(18,248)	(4,616)	
Total stockholders equity	282,496	139,451	155,248	1
Book value per share	$ 11.38	$ 11.91	$ 13.26	$ 0.001

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MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and notes to those statements included elsewhere in this prospectus supplement and the accompanying prospectus. This discussion may contain forward-looking statements that involve risks and uncertainties. The words believe, expect, anticipate, estimate, may, will, or could and similar expressions or the negatives of these words or phrases are intended to identify forward-looking statements. As a result of many factors, such as those set forth under Risk Factors and elsewhere in this prospectus supplement and the accompanying prospectus, our actual results may differ materially from those anticipated in such forward-looking statements.

General

Luminent Mortgage Capital, Inc. is a REIT headquartered in San Francisco, California. We were incorporated in April 2003 to invest primarily in U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities, which we acquire in the secondary market. Substantive operations began mid-June 2003, after completing two private placements of our common stock. Our strategy is to acquire mortgage-related assets, finance these purchases in the capital markets and use leverage in order to provide an attractive return on stockholders equity. Through this strategy, we seek to earn income, which is generated from the spread between the yield on our earning assets and our costs, including the interest cost of the funds we borrow. We have acquired and will seek to acquire additional assets that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments.

Our business is affected by a variety of economic and industry factors which management considers. The most significant risk factors management considers while managing the business which could have a material effect on the financial condition and results of operations are:

- interest rate mismatches between our adjustable-rate and hybrid adjustable-rate mortgage-backed securities and our borrowings used to fund our purchases of mortgage-backed securities;
- increasing or decreasing levels of prepayments on the mortgages underlying our mortgage-backed securities;
- the potential for increased borrowing costs related to repurchase agreements;
- interest rate caps related to our adjustable-rate and hybrid adjustable-rate mortgage-backed securities;
- the overall leverage of our portfolio;
- our ability or inability to use derivatives to mitigate our interest rate and prepayment risks;
- the impact that increases in interest rates would have on our book value**;**
- maintaining adequate borrowing capacity so that we can purchase mortgage-related assets and reach our desired amount of leverage. If we fail to obtain or renew sufficient funding on favorable terms or at all, we will be limited in our ability to acquire mortgage-related assets;

possible market developments could cause our lenders to require us to pledge additional assets as collateral. If our assets are insufficient to meet the collateral requirements, we might be compelled to liquidate particular assets at inopportune times and at disadvantageous prices;

competition might prevent us from acquiring mortgage-backed securities at favorable yields, which would harm our results of operations;

if we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability; and

complying with REIT requirements might cause us to forego otherwise attractive opportunities.

Management has established interest rate risk and other policies for managing the portfolio of mortgage-backed securities and the related borrowings outstanding. These policies include, but are not limited to, evaluating the level of risk we assume when

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purchasing adjustable-rate or hybrid adjustable-rate mortgage-backed securities which are subject to periodic and lifetime interest rate caps, matching the interest rates on our assets and liabilities, acquiring new mortgage-backed securities to replace prepaid securities, purchasing mortgage-backed securities that we believe to have favorable-risk adjusted expected returns relative to the market interest rates at the time of purchase, borrowing between eight and 12 times the amount of our stockholders equity, entering into derivative transactions to protect us from rising interest rates on our repurchase agreements, and monitoring our qualification as a REIT.

Refer to the section titled Risk Factors for additional discussion regarding these and other risk factors which affect our business. Refer to the section Interest Rate Risk of Item 7A, Quantitative and Qualitative Disclosure About Market Risk, for additional interest rate risk discussion.

Critical Accounting Policies

Our financial statements are prepared in accordance with GAAP. These accounting principles require us to make some complex and subjective decisions and assessments. Our most critical accounting policies involve decisions and assessments which could significantly affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our financial statements are based were reasonable at the time made based upon information available to us at that time. See Note 2 to the financial statements for a complete discussion of our significant accounting policies. Management has identified our most critical accounting policies to be the following:

Classifications of Investment Securities

Our investments in mortgage-backed securities are classified as available-for-sale securities which are carried on the balance sheet at their fair value. The classification of the securities as available-for-sale results in changes in fair value being recorded as adjustments to accumulated other comprehensive loss, which is a component of stockholders equity, rather than immediately through earnings. If available-for-sale securities were classified as trading securities, there could be substantially greater volatility in earnings from period-to-period.

Valuations of Mortgage-backed Securities

Our mortgage-backed securities have fair values as determined by management with reference to price estimates provided by independent pricing services and dealers in the securities. Because the price estimates may vary to some degree between sources, management must make certain judgments and assumptions about the appropriate price to use to calculate the fair values for financial reporting purposes. Different judgments and assumptions could result in different presentations of value.

When the fair value of an available-for-sale security is less than amortized cost, management considers whether there is an other-than-temporary impairment in the value of the security. If, in management s judgment, an other-than-temporary impairment exists, the cost basis of the security is written down to the then-current fair value, and the unrealized loss is transferred from accumulated other comprehensive loss as an immediate reduction of current earnings (as if the loss had been realized in the period of impairment). The determination of other-than-temporary impairment is a subjective process, and different judgments and assumptions could affect the timing of loss realization.

Management considers the following factors when evaluating the securities for an other-than-temporary impairment:

The length of the time and the extent to which the market value has been less than the amortized cost;

Whether the security has been downgraded by a rating agency; and

Our intent to hold the security for a period of time sufficient to allow for any anticipated recovery in market value.

The determination of other-than-temporary impairment is evaluated at least quarterly. If we determine an impairment to be permanent we may need to realize a loss that would have an impact on future income.

Interest Income Recognition

Interest income on our mortgage-backed securities is accrued based on the actual coupon rate and the outstanding principal amount of the underlying mortgages. Premiums and discounts are amortized or accreted into interest income over the lives of the securities using the effective yield method adjusted for the effects of estimated prepayments based on Statement of Financial

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Accounting Standards, or SFAS, No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.* If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

Accounting for Derivative Financial Instruments and Hedging Activities

Our policies permit us to enter into derivative contracts, including Eurodollar futures contracts and interest rate swaps, as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements, or hedged items, for a specified future time period.

At December 31, 2003, we have engaged in short sales of Eurodollar futures contracts to mitigate our interest rate risk for the specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. The value of these futures contracts is marked-to-market daily in our margin account with the custodian. Based upon the daily market value of these futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts.

These contracts, or hedge instruments, have been designated as cash flow hedges and are evaluated at inception and on an on-going basis in order to determine whether they qualify for hedge accounting under SFAS No. 133, as amended and interpreted. The hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting. In order to determine whether the hedge instrument is highly effective, we use regression methodology to assess the effectiveness of our hedging strategies. Specifically, at the inception of each new hedge and on an on-going basis, we assess effectiveness using ordinary least squares regression to evaluate the correlation between the rates consistent with the hedge instrument and the underlying hedged items. A hedge instrument is highly effective if the changes in the fair value of the derivative provide offset of at least 80% and not more than 120% of the changes in fair value or cash flows of the hedged item attributable to the risk being hedged. The futures contracts are carried on the balance sheet at fair value. Any ineffectiveness which arises during the hedging relationship, is recognized in interest expense during the period in which it arises. Prior to the end of the specified hedge time period the effective portion of all contract gains and losses (whether realized or unrealized) is recorded in other comprehensive income or loss. Realized gains and losses are reclassified into earnings as an adjustment to interest expense during the specified hedge time period. For REIT taxable net income purposes, realized gains and losses are reclassified into earnings immediately upon contract expiration.

We are not required to account for the futures contracts using hedge accounting as described above. If we decided not to designate the futures contracts as hedges and to monitor their effectiveness as hedges, or if we entered into other types of financial instruments that did not meet the criteria to be designated as hedges, changes in the fair values of these instruments would affect periodic earnings immediately.

Management Incentive Compensation Expense

The Management Agreement provides for the payment of incentive compensation to Seneca if our financial performance exceeds certain benchmarks. Incentive compensation is calculated on a cumulative, quarterly basis for GAAP purposes and on a stand-alone quarterly basis with an annual cumulative reconciliation calculation for incentive compensation payment purposes. During each quarter of the fiscal year, we will calculate the incentive compensation expense quarterly, on a cumulative basis, making any necessary adjustments for any expensed amounts that were recognized in previous quarters. As a result, if we experience poor quarterly performance in a particular quarter and this causes the cumulative incentive compensation expense for the current quarter to be lower than the cumulative incentive compensation for the prior quarter, we will record a negative incentive compensation expense in the current quarter. The incentive compensation is payable one-half in cash and one-half in the form of our restricted common stock.

For the first, second and third quarters of each fiscal year, incentive compensation payments actually paid to Seneca are calculated based upon the net income and relevant performance thresholds solely for the applicable quarter, and a cumulative calculation is performed at the end of the fiscal year. As a result, during the first three quarters of each fiscal year there will be differences between incentive compensation expense, for GAAP purposes, and the incentive compensation amounts actually paid to Seneca. Any differences between these amounts will be reflected on the balance sheet as a receivable due from or payable due to Seneca. In addition, when each annual cumulative incentive compensation calculation and reconciliation is performed, Seneca may be required to return cash incentive compensation payments earlier received or shares of common stock earlier granted, as applicable, to it as part of its incentive compensation payments for the first three quarters of the fiscal year.

The cash portion of the incentive compensation is accrued and expensed during the period for which it is calculated and paid. We account for the restricted stock portion of the incentive compensation in accordance with SFAS No. 123, *Accounting for*

Stock-based Compensation, and related interpretations, and EITF 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.*

This restricted stock portion of the incentive compensation will be paid or issued to Seneca on a quarterly basis pursuant to the terms of the Management Agreement. The number of shares issued is based on (a) one-half of the total incentive compensation for the period, divided by (b) the average of the closing prices of the common stock over the 30 day period ending three days prior to the grant date, less a fair market value discount determined by our board of directors to account for the transfer restrictions during the vesting period. During periods of lower stock prices, we will issue more restricted common stock to Seneca under the Management Agreement to pay for the same amount of incentive compensation earned in periods that had higher stock prices. Over the vesting period, any additional shares issued would have a dilutive effect on book value and earnings per share.

On the date of each restricted stock payment or issuance to Seneca under the Management Agreement, the fair market value of the common stock shall be recorded in the stockholders equity section of our balance sheet as common stock and additional paid-in capital. The corresponding portion of any restricted stock payment that is not expensed will be reflected in the stockholders equity section of our balance sheet as deferred compensation. Each quarter s incentive compensation restricted stock payment or issuance to Seneca will be divided into three tranches. The first tranche will vest over a one-year period and be expensed over a five-quarter period, beginning in the quarter in which it was earned. The second tranche will vest over a two-year period and be expensed over a nine-quarter period beginning in the quarter in which it was earned. The third tranche will vest over a three-year period and be expensed over a thirteen-quarter period beginning in the quarter in which it was earned. As a result of this vesting schedule for the restricted stock issued to Seneca, we will incur incentive compensation expense in each of the periods following the issuance of the restricted stock over a three-year period. We will continue to incur incentive compensation expense related to each restricted stock payment, even in subsequent periods in which Seneca did not earn incentive compensation under the Management Agreement.

As the price of our common stock changes in future periods, the fair value of the unvested portions of shares paid to Seneca pursuant to the Management Agreement shall be marked-to-market, with corresponding entries on the balance sheet. The net effect of any mark-to-market adjustments to the value of the unvested portions of the restricted stock shall be expensed in future periods, on a ratable basis, according to the remaining vesting schedules of each respective tranche of restricted common stock. Accordingly, incentive compensation expense related to the portion of the incentive compensation paid to Seneca in each restricted stock payment or issuance may be higher or lower from one reporting period to the next, and may vary throughout the vesting period. For example, future incentive compensation expense related to previously issued but unvested restricted stock will be higher during periods of increasing stock prices, and lower during periods of decreasing stock prices. In addition, over the vesting period for each restricted stock payment or issuance, our stockholders equity will increase or decrease based upon the current market price of our stock. As a result, this will have the effect of increasing or decreasing our net worth, the factor used in calculating Seneca s base management fee, and may increase or decrease the amount of base management fees in future periods.

Pursuant to the Management Agreement, it is possible for Seneca to earn incentive compensation each quarter and, as a result, receive a restricted stock payment each quarter. As Seneca is paid or issued multiple tranches of restricted common stock for incentive compensation, we will experience increasing management fee expense due to the cumulative impact of multiple tranches and vesting schedules of restricted stock payments, and the mark-to-market impact of the unvested portions of these payments. This will be true even in periods where there is little change in our income or stock price.

We also pay an incentive fee, in the form of cash and restricted stock, to our Chief Financial Officer, in accordance with the terms of his employment agreement. The incentive fee is accounted for in the same manner as the incentive fee earned by Seneca.

Financial Condition

All of our assets at December 31, 2003 were acquired with the proceeds of our June 2003 private placements of 11,500,000 shares of our common stock, our December 2003 initial public offering of 13,110,000 shares of our common stock and use of leverage. We received net proceeds after offering costs of $159.7 million from the private placement offerings, which closed on June 11, 2003 and June 19, 2003, and $157.0 million from the initial public offering, which closed December 24, 2003.

Mortgage-Backed Securities

At December 31, 2003, we held $2.2 billion of mortgage-backed securities at fair value, net of unrealized gains of $1.1 million and unrealized losses of $27.4 million. As of December 31, 2003, all of the mortgage-backed securities in our portfolio were purchased at a premium to their par value and our portfolio had a weighted-average amortized cost of 102.2.

Certain of the securities held at December 31, 2003 are impaired as the fair value of the securities is below amortized cost. At December 31, 2003, our entire portfolio was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. None of the securities held had been downgraded by a credit rating agency since their purchase. In addition, we intend to hold the securities until maturity, allowing for the anticipated recovery in fair value of the securities held. As such, we do not believe any of securities held are other-than-temporarily impaired at December 31, 2003.

The stated contractual final maturity of the mortgage loans underlying our portfolio of mortgage-backed securities ranges up to 30 years, however, the expected maturity is subject to change based on the prepayments of the underlying mortgage loans. The following table sets forth the maturity dates, by year, and percentage composition related to the assets that comprise our investment portfolio as of December 31, 2003:

Asset	Average Final Maturity	% of Total
Adjustable-Rate Mortgage-Backed Securities	2033	8.6 %
Hybrid Adjustable-Rate Mortgage-Backed Securities	2033	88.9%
Balloon Mortgage-Backed Securities	2008	2.5 %
Fixed-Rate Mortgage-Backed Securities	N/A	N/A

Actual maturities of mortgage-backed securities are generally shorter than stated contractual maturities. Actual maturities of our mortgage-backed securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal.

The constant prepayment rate, or CPR, on our mortgage-backed securities for the quarter ended December 31, 2003 was 23%. CPR attempts to predict the percentage of principal that will prepay over the next 12 months based on historical principal paydowns. As interest rates have risen, the rate of refinancings has declined, which we believe may result in lower rates of prepayments and, as a result, a lower portfolio CPR.

As of December 31, 2003, the weighted-average effective duration of the securities in our overall investment portfolio, assuming constant prepayment rates to the balloon or reset date, or the CPB duration, was 1.75 years. CPB is similar to CPR except that it also assumes that the hybrid adjustable-rate mortgage-backed securities prepay in full at their next reset date. As of December 31, 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had fixed interest rates for a weighted-average of approximately 43 months, after which time the interest rates reset and become adjustable. The average length of time until maturity of those mortgages was 30 years. Those mortgages are also subject to interest rate caps that limit the amount that the applicable interest rate can increase during any year, known as an annual cap, and through the maturity of the applicable security, known as a lifetime cap. As of December 31, 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had average annual caps of 2.47% and average lifetime caps of 10.03%.

The following table summarizes our mortgage-backed securities on December 31, 2003 according to their estimated weighted-average life classifications:

Weighted-Average Life	Fair Value	Amortized Cost	Weighted-Average Coupon

	(in thousands)	**(in thousands)**	
Less than one year	$ 299,685	$ 304,556	4.07%
Greater than one year and less than five years	1,829,471	1,850,899	4.09
Greater than five years	32,789	32,843	3.96
Total	$ 2,161,945	$ 2,188,298	4.09%

The weighted-average lives of the mortgage-backed securities at December 31, 2003 in the table above are based upon data provided through a subscription-based financial information service provided by a major investment bank, assuming constant principal prepayment rates to the balloon or reset date for each security. At December 31, 2003, the weighted-average lives were calculated using estimated prepayment speeds or actual prepayment speed history. The weighted-average lives for some of the mortgage-backed securities included in the table above were estimated using expected prepayment speeds for pools, since certain pools were new issues and did not have historical performance data available. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loan, loan age, margin and volatility.

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The actual weighted-average lives of the mortgage-backed securities in our investment portfolio could be longer or shorter than the estimates in the tables above depending on the actual prepayment rates experienced over the life of the applicable securities and is sensitive to changes in both prepayment rates and interest rates.

Equity Securities

Our investment policies allow us to acquire a limited amount of equity securities, including common and preferred shares issued by other real estate investment trusts. At December 31, 2003, we did not hold any equity securities.

Unsettled Securities Purchases

At December 31, 2003, we had unsettled securities purchases of $156.1 million which subsequently settled in January 2004. Of the $156.1 million of unsettled securities purchases, $59.8 million are related to to be announced, or TBA, mortgage-backed securities.

Other Assets

We had other assets of $10.2 million at December 31, 2003. Other assets consist primarily of interest receivable of $7.3 million and principal receivable of $2.3 million.

Hedging Instruments

There can be no assurance that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Moreover, no hedging activity can completely insulate us from the risks associated with changes in interest rates and prepayment rates.

Hedging involves risk and typically involves costs, including transaction costs. The costs of hedging increase dramatically as the period covered by the hedging increases and during periods of rising and volatile interest rates. We may increase our hedging activity and, thus, increase our hedging costs during such periods when interest rates are volatile or rising. We generally intend to hedge as much of the interest rate risk as our manager determines is in the best interest of our stockholders, after considering the cost of such hedging transactions and our desire to maintain our status as a REIT. Our policies do not contain specific requirements as to the percentages or amount of interest rate risk that our manager is required to hedge.

At December 31, 2003, we have engaged in short sales of Eurodollar futures contracts as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements, or hedged item, for a specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. We sold short 2,090 Eurodollar futures contracts, which expire in March 2004, June 2004 and September 2004, with a notional amount totaling $2.1 billion. The value of these futures contracts is marked-to-market daily in our margin account with the custodian. Based upon the daily market value of these futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts. At December 31, 2003, the unrealized loss on the Eurodollar futures contracts was $157 thousand.

Liabilities

We have entered into repurchase agreements to finance some of our acquisitions of mortgage-backed securities. None of the counterparties to these agreements are affiliates of Seneca or us. These agreements are secured by our mortgage-backed securities and bear interest rates that have historically moved in close relationship to LIBOR. As of

December 31, 2003 we had established 17 borrowing arrangements with various investment banking firms and other lenders, 12 of which were in use on December 31, 2003.

At December 31, 2003, we had outstanding $1.7 billion of repurchase agreements with a weighted-average current borrowing rate of 1.19%, $337.3 million of which matures within 30 days, $281.9 million of which matures between 31 and 90 days and $1.1 billion of which matures in greater than 90 days. It is our present intention to seek to renew these repurchase agreements as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements. At December 31, 2003, the repurchase agreements were secured by mortgage-backed securities with an estimated fair value of $1.8 billion and had a weighted-average maturity of 145 days. The net amount at risk, defined as fair value of securities sold, plus accrued interest income, minus repurchase agreement liabilities, plus accrued interest expense, with all counterparties was $83.2 million.

After consideration of the duration on our Eurodollar futures contracts, our weighted-average maturity of our total liabilities was 255 days.

We had $167.9 million of other liabilities at December 31, 2003. Other liabilities consisted primarily of $156.1 million of unsettled securities purchases, $5.3 million of cash distribution payable, $3.8 million of accrued interest expense on repurchase agreements, $1.4 million of accounts payable and accrued expenses, and $1.1 million of management fee payable, incentive fee payable and other related party liabilities.

We have a margin lending facility with our primary custodian from which we may borrow money in connection with the purchase or sale of securities. The terms of the borrowings, including the rate of interest payable, are agreed to with the custodian for each amount borrowed. Borrowings are repayable immediately upon demand of the custodian. At December 31, 2003, there were no outstanding borrowings under the margin lending facility.

Stockholders Equity

Stockholders equity at December 31, 2003 was $282.5 million and included $26.3 million of unrealized losses on mortgage-backed securities available-for-sale and $157 thousand of unrealized losses on cash flow hedges presented as accumulated other comprehensive loss.

Average stockholders equity for the period from June 11, 2003, commencement of operations, through December 31, 2003 was $128.4 million. Return on average equity was 3.85% for the period from June 11, 2003, commencement of operations, through December 31, 2003. Because of the timing of our initial investment of portfolio assets (investment activities began on June 11, 2003, the first security purchase settled on June 16, 2003, and the remainder settled through July 31, 2003), interest income for the period from June 11, 2003 through December 31, 2003 was lower than would be expected for a typical full period, both in an absolute sense and also relative to the average net invested assets for the period. During the period, the U.S. bond markets also experienced dramatic price and yield volatility. Increasing interest rates caused the overall market value of our portfolio to decrease, and our leverage, defined as our total debt divided by stockholders equity, to increase beyond our desired range. In order to deleverage our portfolio we sold securities at a loss. In addition, operating expenses were high in proportion to gross interest income and expense and to net interest income as compared to expectations for full periods of operations because of the costs of start-up operations. As such, return on average equity was lower as compared to expectations for full periods of operations.

Our book value at December 31, 2003 was as follows:

(dollars in thousands, except per share amounts)	**Total Stockholders Equity**	**Book Value per Share (1)**
Total stockholders equity	$ 282,496	$ 11.38
Accumulated other comprehensive loss on mortgage-backed securities	26,353	1.07
Total stockholders equity, excluding accumulated other comprehensive loss on mortgage-backed securities	$ 308,849	$ 12.45

(1) Based on 24,814,000 shares outstanding on December 31, 2003

Management believes that total stockholders equity excluding accumulated other comprehensive loss on mortgage-backed securities is a useful measure to investors because book value unadjusted for temporary declines in the fair values of securities more closely represents the cost basis of our invested assets, net of our leverage, which is the basis for our net interest income and our distributions to stockholders under the tax code governing REIT distributions.

Results of Operations

For the period from April 26, 2003 through December 31, 2003, net income was $2.8 million or $0.27 per weighted-average share (basic and diluted). For the same period, interest income, net of premium amortization, was approximately $22.6 million, and was primarily earned from investments in mortgage-backed securities. Interest expense on short-term borrowings was $9.0 million. Because of the timing of our initial investment of portfolio assets (investment activities began on June 11, 2003), interest income for the period from April 26, 2003 through December 31, 2003 was substantially lower than would be expected for a typical full period, both in an absolute sense and also relative to the average net invested assets for the period. In addition, prepayment activity declined due to the changing interest rate environment and resulted in decreased premium amortization and increased yield on average earning assets.

For the quarter ended December 31, 2003, the weighted-average yield on average earning assets, net of amortization of premium was 2.81% and the weighted-average interest rate on our repurchase agreement liabilities was 1.20% resulting in a net interest margin of 1.61%. Our net interest margin improved during the course of the fourth quarter. For the period from April 26, 2003 through December 31, 2003, net interest margin and its components are not meaningful due to the timing of our initial investments and related borrowings.

Included in net income for the period from April 26, 2003 through December 31, 2003 are net losses on sales of mortgage-backed securities of $7.8 million which occurred during the quarter ended September 30, 2003. Between June 30, 2003 and mid-August 2003, the U.S. bond markets experienced dramatic price and yield volatility. Increasing interest rates caused the overall market value of our portfolio to decrease and our leverage (defined as our total debt divided by stockholders equity) to increase beyond management s desired range. To reduce leverage, we sold securities in mid-August totaling $130.7 million and realized a loss of $2.3 million. In an attempt to protect our portfolio from further increases in interest rates, we sold short $200 million of TBA mortgage securities. Interest rates subsequently declined, and we closed out this short position in the month of September for a total realized loss of $5.7 million. During the third quarter, we also simultaneously sold and purchased securities totaling $215.9 million and $215.7 million, respectively, that resulted in a realized gain on sale of $0.2 million. We did not sell any mortgage-backed securities during the period from April 26 through June 30, 2003 or during the quarter ended December 31, 2003, therefore, there were no gains or losses on sales of securities for these periods. Although we generally intend to hold our investment securities to maturity, Seneca may determine at some time before they mature that it is in our interest to sell them and purchase securities with other characteristics. In that event, our earnings will be affected by realized gains or losses.

Operating expenses for the period from April 26, 2003 through December 31, 2003 were $3.1 million. Operating expenses were high in proportion to gross interest income and expense and to net interest income as compared to expectations for full periods of operations because of the costs of start-up operations.

Base management fees to Seneca under the Management Agreement, which were $901 thousand for the period from April 26, 2003 through December 31, 2003, are based on a percentage of our average net worth. Average net worth for these purposes is calculated on a monthly basis and equals the difference between the aggregate book value of our consolidated assets prior to accumulated depreciation and other non-cash items, including the fair market value adjustment on mortgage-backed securities, minus the aggregate book value of our consolidated liabilities.

Incentive fee expense to related parties for the period from April 26, 2003 through December 31, 2003 was $980 thousand. Incentive compensation is earned by related parties when REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) relative to the average net invested assets for the period, as defined in the Management Agreement, exceeds the threshold return taxable income that would have produced an annualized return on equity equal to the sum of the 10-year U.S. Treasury rate plus 2.0% for the same period. REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) for the period from April 26, 2003 through December 31, 2003 was $11.7 million and was greater than the threshold return taxable income of $5.6 million for the same period. Incentive compensation earned by Seneca during the period from April 26, 2003 through December 31, 2003 was $1.2 million, of which $613 thousand was waived by Seneca for the quarter ended September 30, 2003.

For the quarter ended December 31, 2003, total incentive compensation expense to Seneca was $606 thousand, one-half payable in cash and one-half payable in the form of the Company s common stock as described above. The cash portion of the incentive fee of $303 thousand for the quarter ended December 31, 2003 was expensed in that period as well as 15.2% of the restricted stock portion of the incentive fees, or $46 thousand. The remaining incentive fee for the quarter ended December 31, 2003 of $30 thousand was earned by the Company s Chief Financial Officer, in accordance with the terms of his employment agreement. This portion of the incentive fee is also payable one-half in cash and one-half in the form of a restricted stock award under the Company s 2003 Stock Incentive Plan. The shares are payable and vest over the same vesting schedule as the stock issued to Seneca. The cash portion of the incentive fee of $15 thousand for the quarter ended December 31, 2003 was expensed in that period as well as 15.2% of the restricted stock portion of the incentive fees, or $3 thousand.

We did not pay incentive compensation to Seneca for the quarter ended September 30, 2003 or the period from April 26, 2003 to June 30, 2003. The incentive compensation expense earned by Seneca for the quarter ended September 30, 2003 of $613 thousand was waived by Seneca on a one-time basis only due to the net loss we reported during that same period. The waived incentive fee was accounted for as incentive fee expense and a capital contribution as of September 30, 2003. We do not expect Seneca to waive incentive compensation in the future. REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) for the period from April 26, 2003 through June 30, 2003, was $298 and was less than the threshold return taxable income of $426 and, therefore, no incentive fee was earned by Seneca or paid by us. No incentive compensation was earned or paid to the Chief Financial Officer for the period from April 26, 2003 to September 30, 2003.

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Professional services expense for the period from April 26, 2003 through December 31, 2003 of $477 thousand includes both legal and accounting services provided to us. We experienced relatively higher levels of professional service expenses during our stabilization period as a public company. Included in this balance are organization costs of $163 thousand, and costs related to the filing of our resale shelf registration statement totaling $44 thousand. The insurance expense for the same period of $291 thousand represents amortization of prepaid directors and officers insurance. Custody expense of $115 thousand for the period from April 26, 2003 through December 31, 2003 includes the services provided by our primary custodian. These expenses may vary based on levels of activity within the portfolio. Included in the other general and administrative expenses of $73 thousand for the period from April 26, 2003 through December 31, 2003 are costs related to the filing of our resale shelf registration statement totaling $27 thousand.

REIT taxable net income is calculated according to the requirements of the Internal Revenue Code, rather than GAAP. The following table reconciles GAAP net income to REIT taxable net income for the period from April 26, 2003 through December 31, 2003 (in thousands):

GAAP net income	$ 2,761
Adjustments to GAAP net income:	
Addback of organizational costs expensed during the period	163
Amortization of organizational costs for tax purposes	(18)
Addback of net capital losses in the period	7,831
Addback waived incentive fee for the quarter ended September 30, 2003	613
Addback of stock compensation expense for incentive fee	48
Addback of stock compensation expense for unvested options	3
Net adjustments to GAAP net income	8,640
REIT taxable net income	$ 11,401

We believe that the presentation of our REIT taxable net income is useful to investors because it is directly related to the distributions we are required to make in order to retain our REIT status and to the calculations of the incentive compensation payable to related parties (before deducting incentive compensation, net operating losses and certain other items). There are limitations associated with REIT taxable net income. For example, this measure does not reflect net capital losses during the period and, thus, by itself is an incomplete measure of our financial performance over any period. As a result, our REIT taxable net income should be considered in addition to, and not as a substitute for, our GAAP-based net income as a measure of our financial performance.

Contractual Obligations and Commitments

As of December 31, 2003, we had entered into a Management Agreement with our Manager. See Note 7 to the financial statements for significant terms of the Management Agreement.

Off-Balance Sheet Arrangements

Since inception, we have not maintained any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide additional funding to any such entities. Accordingly, we are not materially exposed to any market, credit, liquidity or financing risk that could arise if we had engaged in such relationships.

Liquidity and Capital Resources

Our primary source of funds as of December 31, 2003 consisted of repurchase agreements totaling $1.7 billion with a weighted-average current borrowing rate of 1.19% which we used to finance acquisition of mortgage-related assets. We expect to continue to borrow funds in the form of repurchase agreements. As of December 31, 2003 we had established 17 borrowing arrangements with various investment banking firms and other lenders, 12 of which were in use on December 31, 2003. Increases in short-term interest rates could negatively impact the valuation of our mortgage-related assets, which could limit our borrowing ability or cause our lenders to initiate margin calls. Amounts due upon maturity of our repurchase agreements will be funded primarily through the rollover/reissuance of repurchase agreements and monthly principal and interest payments received on our mortgage-backed securities. We generally seek to borrow between eight and 12 times the amount of our equity. Our leverage ratio at December 31, 2003 was 6.1. At December 31, 2003, substantially all of the net offering proceeds from our initial public offering had been used to purchase mortgage-backed securities. However, at December 31, 2003, we had not fully levered our portfolio to within our target range of eight to 12 times the amount of our equity. As a result, the total amount of mortgage-backed securities and repurchase agreement liabilities as of December 31, 2003 were lower than they will be once our portfolio is fully levered through additional repurchase agreement liabilities and related mortgage-backed security purchases.

We have a margin lending facility with our primary custodian from which we may borrow money in connection with the purchase or sale of securities. The terms of the borrowings, including the rate of interest payable, are agreed to with the custodian for each amount borrowed. Borrowings are repayable immediately upon demand of the custodian. At December 31, 2003, there were no outstanding borrowings under the margin lending facility.

For liquidity, we also rely on the cash flow from operations, primarily monthly principal and interest payments to be received on our mortgage-backed securities, as well as any primary securities offerings authorized by our board of directors.

On November 17, 2003, we paid a cash distribution of $0.50 per share to our stockholders of record on October 21, 2003. On January 28, 2994, we paid a cash distribution of $0.45 per share to our stockholders of record on December 11, 2003. Both of these distributions are taxable dividends, and neither of these distributions are considered return of capital. The distributions were funded with cash flow from our ongoing operations, including principal and interest payments received on our mortgage-backed securities. We did not distribute $282 thousand of our REIT taxable net income for the period from April 26, 2003 through December 31, 2003. We intend to declare a spillback distribution in this amount during 2004.

We believe that equity capital, combined with the cash flow from operations and the utilization of borrowings, will be sufficient to enable us to meet anticipated liquidity requirements. However, an increase in prepayment rates substantially above our expectations could cause a liquidity shortfall. If our cash resources are at any time insufficient to satisfy our liquidity requirements, we may be required to liquidate mortgage-backed securities or sell debt or additional equity securities. If required, the sale of mortgage-backed securities at prices lower than the carrying value of such assets would result in losses and reduced income.

We intend to increase our capital resources by making additional offerings of equity and debt securities, possibly including classes of preferred stock, common stock, commercial paper, medium-term notes, collateralized mortgage obligations and senior or subordinated notes. Such financing will depend on market conditions for capital raises and for the investment of any proceeds. All debt securities, other borrowings, and classes of preferred stock will be senior to the common stock in a liquidation of our Company.

Inflation

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with accounting principles generally accepted in the United States and our distributions are determined by our board of directors based primarily by our net income as calculated for tax purposes; in each case, our activities and balance sheet are measured with reference to historical cost and or fair market value without considering inflation.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our primary component of market risk is interest rate risk, as described below. While we do not seek to avoid risk completely, we do seek to assume risk that can be quantified from historical experience, to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

Interest Rate Risk

We are subject to interest rate risk in connection with our investments in fixed-rate, adjustable-rate and hybrid adjustable-rate mortgage-backed securities and our related debt obligations, which are generally repurchase agreements of limited duration that are periodically refinanced at current market rates, and our derivative contracts.

Effect on Net Interest Income

We fund our investments in some long-term, fixed-rate and hybrid adjustable-rate mortgage-backed securities with short-term borrowings under repurchase agreements. During periods of rising interest rates, the borrowing costs associated with those fixed-rate and hybrid-adjustable rate mortgage-backed securities tend to increase while the income earned on such fixed-rate and hybrid adjustable-rate mortgage-backed securities (during the fixed-rate component of such securities) may remain substantially unchanged. This results in a narrowing of the net interest spread between the related assets and borrowings and may even result in losses.

As a means to mitigate the negative impact of a rising interest rate environment, we have entered into derivative transactions, specifically Eurodollar futures contracts. Hedging techniques are based, in part, on assumed levels of prepayments of our fixed-rate and hybrid adjustable-rate mortgage-backed securities. If prepayments are slower or faster than assumed, the life of the mortgage-backed securities will be longer or shorter which would reduce the effectiveness of any hedging strategies we may utilize and may result in losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns. Our hedging activity will also be limited by the asset and sources-of-income requirements applicable to us as a REIT.

Extension Risk

We invest in fixed-rate and hybrid adjustable-rate mortgage-backed securities. Hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter their interest rates reset periodically on the same basis as adjustable-rate mortgage-backed securities. As of December 31, 2003, 88.9% of our investment portfolio was comprised of hybrid adjustable-rate mortgage-backed securities. We compute the projected weighted-average life of our fixed-rate and hybrid adjustable-rate mortgage-backed securities based on the market s assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a fixed-rate or hybrid adjustable-rate mortgage-backed security is acquired with borrowings, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related mortgage-backed security. This strategy is designed to protect us from rising interest rates because the borrowing costs are fixed for the duration of the fixed-rate portion of the related mortgage-backed security. However, if prepayment rates decrease in a rising interest rate environment, the life of the fixed-rate portion of the related mortgage-backed security could extend beyond the term of the swap agreement or other hedging instrument. This situation could negatively impact us as borrowing costs would no longer be fixed after the end of the hedging instrument while the income earned on the fixed-rate or hybrid adjustable-rate mortgage-backed security would remain fixed. This situation may also cause the market value of our fixed-rate and hybrid adjustable-rate mortgage-backed securities to decline with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets and incur losses to maintain adequate liquidity.

Adjustable-Rate and Hybrid Adjustable-Rate Mortgage-Backed Security Interest Rate Cap Risk

We also invest in adjustable-rate and hybrid adjustable-rate mortgage-backed securities which are based on mortgages that are typically subject to periodic and lifetime interest rate caps and floors, which limit the amount by which an adjustable-rate or hybrid adjustable-rate mortgage-backed security s interest yield may change during any given period. However, our borrowing costs pursuant to our repurchase agreements will not be subject to similar restrictions. Therefore, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation by caps, while the intere