

CAPSTEAD MORTGAGE CORP  
 Form 424B5  
 March 09, 2015

CALCULATION OF REGISTRATION FEE<sup>(1)</sup>

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price Per Unit <sup>(2)</sup>	Proposed Maximum Aggregate Offering Price	Amount Of Registration Fee <sup>(3)</sup>
Common Stock, \$0.01 par value per share	15,000,000	\$ 11.99	\$179,850,000	\$20,898.57

- This "Calculation of Registration Fee" table shall be deemed to update the "Calculation of Registration Fee" table in Registration Statement on Form S-3 of Capstead Mortgage Corporation (File No. 333-201611) in accordance with
- (1) Rules 456(b) and 457(r) under the Securities Act of 1933. Payment of additional registration fees due under Registration Statement No. 333-201611 was deferred pursuant to Rules 456(b) and 457(r) of the Securities Act.
- (2) Estimated solely for the purpose of determining the registration fee pursuant to Rule 457(c), based on the average of the high and low prices of the common stock as reported on the New York Stock Exchange on March 5, 2015. The filing fee of \$20,898.57 is calculated in accordance with Rule 457(r) under the Securities Act of 1933, as amended. At the time of filing the registrant's registration statement on Form S-3ASR filed with the Securities and
- (3) Exchange Commission on January 20, 2015 (File No. 333-201611), the registrant had unused fees of \$9,837 from unsold securities under Registration Statement No. 333-179607, filed February 21, 2012 (paid in connection with a 424(b)(5) filing on February 23, 2012 relating to the issuance of the registrant's common stock), which fees will be offset against the total filing fee due at this time.

**Prospectus Supplement**

Filed pursuant to Rule 424(b)(5)

**(To prospectus dated January 20, 2015)** Registration No. 333-201611

Capstead Mortgage Corporation

15,000,000 Shares

Common Stock

Through this prospectus supplement, Capstead Mortgage Corporation may offer and sell from time to time up to 15,000,000 shares of our common stock. Our common stock is listed on the New York Stock Exchange under the symbol "CMO".

We may sell all or a portion of the shares of common stock offered pursuant to this prospectus supplement through agents or to or through underwriters or dealers. We are a party to a sales agreement with IFS Securities, Inc. (dba Brinson Patrick, a division of IFS Securities, Inc.) as sales manager, relating to the sale of shares of common stock offered pursuant to this prospectus supplement. The sales manager is not required to sell any specific number or dollar amount of shares, but will use its best efforts to sell the shares of common stock offered by this prospectus supplement, subject to direction from us as to amount and timing. Such sales will be at market prices prevailing at the time of the sale. On March 5, 2015, the last reported sales price on the New York Stock Exchange of our common stock was \$11.97 per share. The compensation to the sales manager for sales of common stock pursuant to this prospectus supplement will be at maximum commission rates ranging from 1.0% to 3.0% of the gross sales price per share, depending upon the aggregate sales proceeds raised by the sales manager under the sales agreement and the timing of such sales, or at such other commission rates as we and the sales manager mutually agree upon. The sales manager will be deemed to be an underwriter, within the meaning of the Securities Act of 1933, as amended (the "Securities Act"), in connection with any sales of common stock on our behalf. See "Description of Sales Agreement" and "Plan of Distribution."

Investing in these securities involves various risks. Risks associated with an investment in these securities are described under "Risk Factors" beginning on page 1 in the accompanying prospectus and in certain of our filings with the Securities and Exchange Commission.

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

The date of this prospectus supplement is March 6, 2015.

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IMPORTANT NOTICE ABOUT INFORMATION IN THIS PROSPECTUS SUPPLEMENT

This document is in two parts. The first part is the prospectus supplement, which describes the specific terms of this offering and also adds to and updates information contained in the accompanying base prospectus and the documents incorporated by reference into this prospectus supplement and the accompanying base prospectus. The second part, the base prospectus, gives more general information about securities we may offer from time to time, some of which does not apply to this offering. Generally, when we refer only to the prospectus, we are referring to both parts combined, and when we refer to the accompanying prospectus, we are referring to the base prospectus.

If the description of this offering varies between this prospectus supplement and the accompanying prospectus, you should rely on the information in this prospectus supplement.

You should rely only on the information contained in or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with information that is different. If anyone provides you with different or inconsistent information, you should not rely on it. We are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where offers and sales are permitted. The information contained in or incorporated by reference into this document is accurate only as of the date such information was issued, regardless of the time of delivery of this prospectus supplement or any sale of our common stock.

## OUR COMPANY

We are a self-managed real estate investment trust, or REIT, formed in 1985 and based in Dallas, Texas. We earn income from investing in a leveraged portfolio of short-duration residential adjustable-rate mortgage pass-through securities, referred to as ARM securities, issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the “GSEs”), or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae are referred to as agency guaranteed securities and are considered to have limited, if any, credit risk. This strategy differentiates us from our peers because ARM loans underlying our investment portfolio can reset to more current interest rates within a relatively short period of time. This positions us to benefit from a potential recovery in financing spreads that typically contract during periods of rising interest rates and can result in smaller fluctuations in portfolio values compared to portfolios containing a significant amount of longer-duration ARM and fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk.

## THE OFFERING

Issuer Capstead Mortgage Corporation.

Common stock offered by us Up to 15,000,000 shares.

Common stock to be outstanding after this offering Up to 110,812,050 shares.

Manner of offering Best efforts, “at-the-market” offering that may be made from time to time through IFS Securities, Inc. (dba Brinson Patrick, a division of IFS Securities, Inc.), as sales manager, subject to direction from us as to amount and timing. See “Plan of Distribution” on page S-3

NYSE symbol CMO

Use of proceeds We intend to use the net proceeds from this offering for general corporate purposes, including, without limitation, repayment of maturing obligations, financing future portfolio acquisitions, capital expenditures and working capital. Pending any such uses, we may invest the net proceeds from the sale of any stock offered pursuant to this prospectus supplement in short-term investments, or may use the net proceeds to reduce short-term indebtedness.

Risk factors An investment in our common stock involves various risks. Risks associated with an investment in these securities are described under the heading “Risk Factors” beginning on page 1 of the accompanying prospectus and in certain of our filings with the Securities and Exchange Commission.

Unless otherwise indicated, all offering information in this prospectus supplement is based on the number of shares of common stock and number of options to purchase shares of common stock outstanding as of March 5, 2015. Unless otherwise indicated, that number of shares of common stock does not include (i) shares of our common stock issuable upon the exercise of outstanding options granted pursuant to our long-term incentive plans or (ii) shares of our common stock issuable upon the conversion of our Series E Preferred Stock in the event we do not elect to redeem the Series E Preferred Stock prior to a change of control conversion date.



## USE OF PROCEEDS

We intend to use the net proceeds from this offering for general corporate purposes, including, without limitation, repayment of maturing obligations, financing future portfolio acquisitions, capital expenditures and working capital. Pending any such uses, we may invest the net proceeds from the sale of any stock offered pursuant to this prospectus supplement in short-term investments, or may use the net proceeds to reduce short-term indebtedness.

## DESCRIPTION OF SALES AGREEMENT

We may sell our common stock from time to time (1) through arrangements with underwriters or dealers, (2) directly to one or more purchasers, or (3) through agents. We have entered into a sales agreement with IFS Securities, Inc. (dba Brinson Patrick, a division of IFS Securities, Inc.) with respect to sales of shares of our common stock and our Series E Preferred Stock, and we may enter into other sales agreements with other sales agents or underwriters in the future. Under the terms of the Brinson Patrick sales agreement, we may issue and sell shares of our common stock from time to time through Brinson Patrick, as our sales agent. Brinson Patrick is not required to arrange for the purchase or sale of any specific number of shares or dollar amount of common stock. We have agreed to provide indemnification and contribution to Brinson Patrick against certain liabilities, including liabilities under the Securities Act.

All sales made pursuant to the Brinson Patrick sales agreement will be reported in our Securities Exchange Act of 1934 reports.

### Certain Terms of the Sales Agency Agreement

Subject to direction from us as to the amount and timing of sales, sales pursuant to the Brinson Patrick sales agreement may be effected on a daily basis. The compensation to Brinson Patrick for sales of our securities under the Brinson Patrick sales agreement, including both common stock and Series E Preferred Stock, shall be at the following commission rates:

3.0% of the gross sales price per share ("sales proceeds") for the first \$8 million of aggregate sales proceeds raised under the sales agreement in each sales period;

5.5% of sales proceeds for the next \$4 million of aggregate sales proceeds raised in each sales period;

8.0% of sales proceeds for the next \$88 million of aggregate sales proceeds raised in each sales period; and

10.0% of sales proceeds for any additional aggregate sales proceeds raised in each sales period.

Notwithstanding the commission structure described above, we and Brinson Patrick can mutually agree in writing to modify the commission rates, but such modified rates cannot exceed the rates described above at each applicable level. For purposes of determining the appropriate commission rates, the initial "sales period" began on March 10, 2008 and will end on December 31, 2015, and each subsequent sales period shall be for a two year period, commencing on January 1 and ending on December 31 of the following calendar year. The remaining proceeds, after further deduction for any transaction fees imposed by any governmental or self-regulatory organization in respect to such sale shall constitute the net proceeds to us for such shares of stock. The commission rate is currently set at a maximum of 1.0% of sales proceeds.

The offering of common stock pursuant to the Brinson Patrick sales agreement will terminate upon the termination of the Brinson Patrick sales agreement. The Brinson Patrick sales agreement may be terminated by us or by Brinson Patrick upon written notice and in certain other circumstances specified therein.

PLAN OF DISTRIBUTION

In connection with the sale of the common stock on our behalf under the Brinson Patrick sales agreement, Brinson Patrick will be deemed to be an “underwriter” within the meaning of the Securities Act, and the compensation payable to Brinson Patrick under the Brinson Patrick sales agreement will be deemed to be an underwriting commission or discount; however, Brinson Patrick is not purchasing or selling any common stock nor is it required to arrange for the purchase or sale of any specific number of shares or dollar amount of common stock. We have separately agreed to provide indemnification and contribution to Brinson Patrick against certain civil liabilities, including liabilities under the Securities Act. Brinson Patrick may engage in transactions with, or perform services for, us in the ordinary course of business.

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We will maintain a trading account at the clearing agent designated by Brinson Patrick to facilitate the transactions contemplated by the Brinson Patrick sales agreement. The net proceeds from the sale of the common stock under the Brinson Patrick sales agreement will be available in the trading account on the third business day (or such other day as is industry practice for regular-way trading) following each sale of common stock (each, a "Settlement Date"). We will effect the delivery of the applicable number of shares of common stock to an account designated by Brinson Patrick at The Depository Trust Company on or before the settlement date of each sale hereunder. Brinson Patrick's compensation will be withheld from the sales proceeds on each settlement date and will be paid to Brinson Patrick.

The offering of our common stock pursuant to the Brinson Patrick sales agreement will terminate upon the termination of the Brinson Patrick sales agreement. The Brinson Patrick sales agreement may be terminated by us or by Brinson Patrick upon written notice and in certain other circumstances specified therein.

Commissions

The following tables show the public offering prices, underwriting commissions and proceeds, before expenses, to us, assuming all 15,000,000 shares of common stock are sold at \$11.97 per share, the last reported sales price of our common stock on the New York Stock Exchange on March 5, 2015.

<u>Common Stock</u>	Per	
	Share*	Total**
Public offering price	\$ 11.97	\$ 179,550,000
Underwriting commissions (1.0%)	\$ 0.1197	\$ 1,795,500
Proceeds, before expenses, to us	\$ 11.8503	\$ 177,754,500

This is an offering that will be made, if at all, from time to time at the then-prevailing market prices. Therefore, \*there can be no assurances that the public offering prices, underwriting commissions, and proceeds, before expenses, will be as set forth above. The commissions are computed based upon the current maximum rate under the Brinson Patrick sales agreement.

\*\*Based upon the maximum commission rate for aggregate proceeds in excess of \$100 million, which is the commission rate applicable as of the date of this prospectus supplement through December 31, 2015.

The expenses of the offering, not including underwriting commissions, are estimated at less than \$50,000 and are payable by us.

LEGAL MATTERS

Certain legal matters in connection with this offering will be passed upon for us by Andrews Kurth LLP, Dallas, Texas. Certain Maryland law matters in connection with this offering will be passed upon for us by Hogan Lovells US LLP (US). Andrews Kurth LLP will rely on the opinion of Hogan Lovells US LLP (US) as to all matters of Maryland law.



PROSPECTUS  
COMMON STOCK  
PREFERRED STOCK  
DEBT SECURITIES  
WARRANTS

Capstead Mortgage Corporation intends to offer and sell from time to time the securities described in this prospectus.

We will provide the specific terms of any securities we may offer in a supplement to this prospectus. You should carefully read this prospectus and any applicable prospectus supplement before deciding to invest in these securities.

The securities may be offered directly, through agents designated by us from time to time, or through underwriters or dealers, on a continuous or delayed basis. We may make any sales of our common shares under this prospectus, if any, on or through the facilities of the New York Stock Exchange, to or through a market maker, or to or through an electronic communications network, at market prices prevailing at the time of sale, or in any other manner permitted by law (including, without limitation, privately negotiated transactions).

Our common stock is listed on the New York Stock Exchange under the symbol "CMO." On January 16, 2015, the last reported sale price of our common stock as reported was \$12.29 per share.

Investing in our securities involves risks. See "Risk Factors" beginning on page 1 of this prospectus for information regarding risks associated with an investment in our securities.

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 January 20, 2015.

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You should rely only on the information contained or incorporated by reference in this prospectus. We have not authorized anyone else to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. An offer to sell these securities will not be made in any jurisdiction where the offer and sale is not permitted. You should assume that the information appearing in this prospectus, as well as information we previously filed with the Securities and Exchange Commission and incorporated by reference, is accurate as of the date on the front cover of this prospectus only. Our business, financial condition, results of operations and prospects may have changed since that date.

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ABOUT THIS PROSPECTUS

This prospectus is part of a shelf registration statement. We may sell, from time to time, in one or more offerings, any combinations of the securities described in this prospectus. This prospectus only provides you with a general description of the securities we may offer. Each time we sell securities under this prospectus, we will provide a prospectus supplement that contains specific information about the terms of the securities. The prospectus supplement may also add, update or change information contained in this prospectus. You should read both this prospectus and any prospectus supplement together with the additional information described under the heading “Where You Can Find More Information.”

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, proxy statements and other documents with the Securities and Exchange Commission (the “SEC”) under the Securities Exchange Act of 1934. You may read and copy any materials that we file with the SEC without charge at the public reference room of the Securities and Exchange Commission, 450 Fifth Street, N.W., Room 1024, Washington, DC 20549. Information about the operation of the public reference room may be obtained by calling the SEC at 1-800-SEC-0330. Also, the SEC maintains an internet website that contains reports, proxy and information statements, and other information regarding issuers, including Capstead, that file electronically with the SEC. The public can obtain any documents that we file with the SEC at [www.sec.gov](http://www.sec.gov).

We also make available free of charge on or through our internet website ([www.capstead.com](http://www.capstead.com)) our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and, if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

This prospectus is part of a registration statement on Form S-3 that we filed with the SEC. This prospectus does not contain all of the information set forth in the registration statement and exhibits and schedules to the registration statement. For further information with respect to our company and our securities, reference is made to the registration statement, including the exhibits and schedules to the registration statement. Statements contained in this prospectus as to the contents of any contract or other document referred to in this prospectus are not necessarily complete and, where that contract is an exhibit to the registration statement, each statement is qualified in all respects by reference to the exhibit to which the reference relates.

INCORPORATION OF INFORMATION BY REFERENCE

The SEC allows us to “incorporate by reference” the information we file with them, which means that we can disclose important information to you by referring you to other documents that we file with the SEC. These incorporated documents contain important business and financial information about us that is not included in or delivered with this prospectus. The information incorporated by reference is considered to be part of this prospectus, and later information filed with the SEC will update and supersede this information.

We incorporate by reference the documents listed below and any future filings we make with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 until the offering of securities covered by this prospectus is complete:

- our Annual Report on Form 10-K for the year ended December 31, 2013;
- our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2014, June 30, 2014 and September 30, 2014; and
- our Current Reports on Form 8-K filed with the SEC on February 3, 2014, May 30, 2014, and January 6, 2015.



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You may obtain copies of these documents at no cost by writing or telephoning us at the following address:

Investor Relations  
Capstead Mortgage Corporation  
8401 N. Central Expressway, Suite 800  
Dallas, Texas 75225  
(214) 874-2323

A WARNING ABOUT FORWARD-LOOKING STATEMENTS

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

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

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking

statements. Forward-looking statements speak only as of the date the statement is made, and we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.

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OUR COMPANY

We are a self-managed real estate investment trust, or REIT, formed in 1985 and based in Dallas, Texas. We earn income from investing in a leveraged portfolio of short-duration residential adjustable-rate mortgage pass-through securities, referred to as ARM securities, issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac, together the GSEs, or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae are referred to as Agency Securities and are considered to have limited, if any, credit risk, because of federal government support for the GSEs.

This strategy differentiates us from our peers because ARM loans underlying our investment portfolio can reset to more current interest rates within a relatively short period of time. This positions us to benefit from a potential recovery in financing spreads that typically contract during periods of rising interest rates and can result in smaller fluctuations in portfolio values compared to portfolios containing a significant amount of longer-duration ARM and fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements and a shorter duration generally indicates less interest rate risk.

We and our qualified REIT subsidiaries have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"), and intend to continue to do so. As a result of this election, we and our qualified REIT subsidiaries are not taxed at the corporate level on taxable income distributed to stockholders, provided that certain REIT qualification tests are met. Certain of our affiliates, which may be consolidated with us for financial reporting purposes, may not be consolidated for federal income tax purposes because such entities may elect taxable REIT subsidiary tax status. All taxable income of any such taxable REIT subsidiaries would be subject to federal and state income taxes, where applicable.

Our principal executive offices are located at 8401 N. Central Expressway, Suite 800, Dallas, Texas 75225. Our telephone number is (214) 874-2323. Our website is <http://www.capstead.com>. The contents of our website are not a part of this prospectus. Our shares of common stock are traded on the New York Stock Exchange, or the "NYSE," under the symbol "CMO."

RISK FACTORS

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

Risks Related to Our Business

Monetary policy actions by the Federal Reserve could adversely affect our liquidity, financial condition and earnings. Over the last six years the Federal Reserve has employed a number of new policy initiatives, most notably the purchase of U.S. Treasury securities and Agency Securities. This expansion of the Federal Reserve's balance sheet is often referred to as quantitative easing or QE. The policy goals of the QE initiatives have been to support the GSEs and the housing markets, and otherwise improve economic and labor market conditions by exerting downward pressure on longer term interest rates, including mortgage interest rates.

Under the last QE initiative that began in September 2012 (referred to as QE3), the Federal Reserve had been purchasing \$45 billion a month in long-term Treasury securities and \$40 billion a month in fixed-rate Agency

Securities, as well as replacing run off of existing holdings of fixed-rate Agency Securities. In December 2013 the Federal Reserve announced that beginning in January 2014 it was reducing purchases of Treasuries and Agency Securities by \$5 billion each and ceased buying additional Treasury and Agency Securities after its October 2014 meeting, while continuing to replace portfolio runoff until after it begins raising short-term interest rates.



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In general, QE elevated pricing for Agency Securities resulting in declining yields on new purchases and lower mortgage interest rates, resulting in higher mortgage prepayment rates. Our net interest margins, and therefore earnings, have been adversely affected over time as existing, lower-cost portfolio is replaced with higher-cost, lower-yielding securities. See discussion below regarding the negative effects of higher mortgage prepayment levels.

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

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

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

Failure of the federal government to periodically increase the U.S. Treasury's borrowing capacity while reducing future federal budget deficits could adversely impact our liquidity, financial condition and earnings. The increasing amount of outstanding federal debt relative to the size of the U.S. economy, particularly in light of projected growth in federal government spending and resulting federal budget deficits, have increased the possibility of further credit rating agency actions to downgrade the federal government's credit rating. This could eventually lead to a decline in the market's perception of the creditworthiness of the federal government. Because market participants rely on the federal government's continued support of the GSEs, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings of Agency Securities could be adversely affected. In addition, these circumstances could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of borrowings under repurchase arrangements which could adversely impact our liquidity, earnings and book value per common share, as more fully described below.



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Legislative and regulatory actions could adversely affect the availability and/or terms and conditions of borrowings under repurchase arrangements and consequently, our liquidity, financial condition and earnings. In July 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank”) in order to restrict certain business practices of systemically significant participants in the financial markets, which include many of our lending counterparties. Additionally, changes in regulatory capital requirements and other leverage constraints are being implemented worldwide. It remains unclear how significant of an impact Dodd Frank and changes in regulatory capital requirements will have on the financial markets in general and on our strategy of holding an appropriately hedged, leveraged portfolio of Agency Securities. However, it is possible that the availability and/or terms and conditions of borrowings under repurchase arrangements and related derivative financial instruments held for hedging purposes could be adversely affected which could adversely affect our liquidity, earnings and book value per common share, as more fully described below.

Government-supported mortgagor relief programs could adversely affect our liquidity, financial condition and earnings. U.S. policy makers have established programs designed to provide qualified homeowners with assistance in avoiding foreclosure or in qualifying for the refinancing of their existing mortgages, which typically entails the payoff of existing mortgages with any losses absorbed by the GSEs. A significant expansion of these mortgagor relief programs, as well as any future legislative or regulatory actions, could increase mortgage prepayments which could reduce the expected life of our residential mortgage investments; therefore, actual yields we realize on these investments could be lower due to faster amortization of investment premiums which could adversely affect earnings. A significant expansion of these programs also could adversely affect book value per common share because of the elimination of any unrealized gains on that portion of the portfolio that prepays. Additionally, heightened prepayment exposure due to the real or perceived potential for government intervention could adversely affect pricing for Agency Securities in general and, as a result, liquidity and book value per common share could be adversely affected due to declines in the fair value of our remaining portfolio.

An increase in prepayments may adversely affect our liquidity, financial condition and earnings. When short- and long-term interest rates are at nearly the same levels (i.e., a “flat yield curve” environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of our portfolio of residential mortgage investments; therefore, actual yields we realize can be lower due to faster amortization of investment premiums, which could adversely affect earnings. High levels of mortgage prepayments can also lead to larger than anticipated demands on our liquidity from our lending counterparties, as more fully described below. Additionally, periods of high prepayments can adversely affect pricing for Agency Securities in general and, as a result, book value per common share can be adversely affected due to declines in the fair value of our remaining portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

Changes in interest rates, whether increases or decreases, may adversely affect our liquidity, financial condition and earnings. Our earnings depend primarily on the difference between the interest received on our residential mortgage investments and the interest paid on our related borrowings, net of the effect of derivatives held for hedging purposes. We finance our investments at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying our securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on related borrowings not effectively fixed through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more extreme circumstances, negative financing spreads and, therefore, adversely affect earnings.

Because rising interest rates tend to put downward pressure on financial asset prices, we may be presented with substantial margin calls during such periods adversely affecting our liquidity. If we are unable or unwilling to pledge additional collateral, our lenders can liquidate our collateral, potentially under adverse market conditions, resulting in losses. At such times we may determine that it is prudent to sell assets to improve our ability to pledge sufficient

collateral to support our remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

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

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Periods of illiquidity in the mortgage markets may reduce amounts available to be borrowed under our repurchase arrangements due to declines in the perceived value of related collateral, which could adversely impact our liquidity, financial condition and earnings. We generally finance our residential mortgage investments by pledging them as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis. The amount borrowed under a repurchase arrangement is limited to a percentage of the estimated market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by the lender that is not advanced under the repurchase arrangement is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the perceived market value of the pledged collateral as determined by our lenders declines, we may be subject to margin calls wherein the lender requires us to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, we may be presented with substantial margin calls during such periods. If we are unable or unwilling to pledge additional collateral, our lenders can liquidate our collateral, potentially under adverse market conditions, resulting in losses. At such times we may determine that it is prudent to sell assets to improve our ability to pledge sufficient collateral to support our remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

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

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

Our use of repurchase arrangements to finance our investments may expose us to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to us. Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a

simultaneous agreement to repurchase the transferred assets at a future date. This may make it difficult for us to recover our pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to us and subject us to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

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Our use of repurchase arrangements to finance our investments may give our lending counterparties greater rights if we seek bankruptcy protection, exposing us to losses. Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. If we file for bankruptcy, our lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses to the extent of any margin amounts held by the lending counterparties.

We may sell assets for various reasons, including a change in our investment focus, which could increase earnings volatility. We may periodically sell assets to enhance our liquidity during periods of market illiquidity or rising interest rates or we may change our investment focus requiring us to sell some portion of our existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-dated repurchase arrangements or interest rate swap agreements, could increase our earnings volatility.

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

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

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

We are dependent on our executives and employees and the loss of one or more of our executive officers could harm our business and our prospects. As a self-managed REIT with only 14 employees, we are dependent on the efforts of

our key officers and employees, most of whom have significant experience in the mortgage industry. Although our named executive officers and some of our other employees are parties to severance agreements, our key officers and employees are not subject to employment agreements with non-compete clauses, nor have we acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on our operations.

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Risks Related to Our Status as a REIT and Other Tax Matters

If we do not qualify as a REIT, we will be subject to