Western Asset Mortgage Capital Corp
Form 10-Q
May 12, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2014

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission File Number: 001-35543

Western Asset Mortgage Capital Corporation

(Exact name of Registrant as specified in its charter)

Delaware	**27-0298092**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

Western Asset Mortgage Capital Corporation

385 East Colorado Boulevard

Pasadena, California 91101

(Address of Registrant s principal executive offices)

(626) 844-9400

(Registrant s telephone number, including area code)

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

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

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 under the Securities Exchange Act of 1934). Yes o No x

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

As of May 7, 2014, there were 41,718,467 shares, par value $0.01, of the registrant s common stock issued and outstanding.

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Western Asset Mortgage Capital Corporation

Balance Sheets (Unaudited)

(in thousands except share and per share data)

	March 31, 2014	December 31, 2013
Assets:		
Cash and cash equivalents	$ 5,492	$ 48,525
Mortgage-backed securities, at fair value ($3,100,433 and $2,818,947 pledged as collateral, at fair value, respectively)	3,247,794	2,853,587
Linked transactions, net, at fair value	2,973	18,559
Investment related receivable ($2,416 and $0 pledged as collateral, at fair value, respectively)	2,556	341
Accrued interest receivable	14,529	12,266
Due from counterparties	57,821	55,434
Derivative assets, at fair value	66,736	105,826
Other assets	383	339
Total Assets	$ 3,398,284	$ 3,094,877
Liabilities and Stockholders Equity:		
Liabilities:		
Borrowings under repurchase agreements	$ 2,822,961	$ 2,579,067
Accrued interest payable	10,298	12,534
Investment related payables	104,526	
Due to counterparties	34,013	65,861
Derivative liability, at fair value	20,753	4,673
Accounts payable and accrued expenses	1,270	1,353
Underwriting and offering costs payable	153	8
Payable to related party	2,006	1,842
Dividend payable	18,136	19,445
Total Liabilities	3,014,116	2,684,783
Commitments and contingencies		
Stockholders Equity:		
Common stock, $0.01 par value, 500,000,000 shares authorized, 27,068,467 and 26,853,287 shares issued and outstanding, respectively	270	268
Preferred stock, $0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	544,796	544,143
Retained earnings (accumulated deficit)	(160,898)	(134,317)
Total Stockholders Equity	384,168	410,094
Total Liabilities and Stockholders Equity	$ 3,398,284	$ 3,094,877

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Operations (Unaudited)

(in thousands except share and per share data)

		For the three months ended March 31, 2014		For the three months ended March 31, 2013
Net Interest Income:				
Interest income	$	23,430	$	33,750
Interest expense		3,390		5,181
Net Interest Income		20,040		28,569
Other Income (Loss):				
Interest income on cash balances and other income (loss), net		(12)		33
Realized gain (loss) on sale of Mortgage-backed securities and other securities, net		3,716		(11,660)
Other loss on Mortgage-backed securities		(1,709)		(2,268)
Unrealized gain (loss) on Mortgage-backed securities and other securities, net		31,091		(54,759)
Gain on linked transactions, net		2,219		596
Gain (loss) on derivative instruments, net		(59,906)		14,840
Other Income (Loss), net		(24,601)		(53,218)
Operating Expenses:				
General and administrative (includes $588 and $286 non-cash stock based compensation, respectively)		2,075		1,737
Management fee related party		1,805		2,113
Total Operating Expenses		3,880		3,850
Net loss available to Common Stock and participating securities	$	(8,441)	$	(28,499)
Net loss per Common Share Basic	$	(0.32)	$	(1.18)
Net loss per Common Share Diluted	$	(0.32)	$	(1.18)
Dividends Declared per Share of Common Stock	$	0.67	$	

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Changes in Stockholders Equity (Unaudited)

(in thousands except shares and share data)

	Common Stock		Additional Paid-In Capital	Retained Earnings (Accumulated) Deficit	Total
	Shares	Par			
Balance at December 31, 2013	26,853,287	$ 268	$ 544,143	$ (134,317)	$ 410,094
Grants of restricted stock	215,180	2	(2)		
Vesting of restricted stock			651		651
Net loss				(8,441)	(8,441)
Dividends on common stock			4	(18,140)	(18,136)
Balance at March 31, 2014	27,068,467	$ 270	$ 544,796	$ (160,898)	$ 384,168

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Cash Flows (Unaudited)

(in thousands)

	For the three months ended March 31, 2014	For the three months ended March 31, 2013
Cash flows from operating activities:		
Net loss	$ (8,441)	$ (28,499)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Premium amortization and (discount accretion), net	3,223	8,625
Restricted stock amortization expense	588	270
Unrealized (gain) loss on Mortgage-backed securities and other securities, net	(31,091)	54,759
Mark-to-market adjustments on linked transactions	(104)	(579)
Mark-to-market adjustments on derivative instruments	56,390	1,097
Other loss on Mortgage-backed securities	1,709	2,268
Realized (gain) loss on sale of Mortgage-backed securities and other securities, net	(3,716)	11,660
Realized loss on sale of Interest-Only Strips accounted for as derivatives, net	869	99
Realized gain on sale of TBAs, net	(2,370)	(601)
Realized gain on linked transaction, net	(1,290)	
Changes in operating assets and liabilities:		
Decrease (increase) in accrued interest receivable	(2,263)	2,039
Decrease (increase) in other assets	101	(85)
Increase (decrease) in accrued interest payable	(2,236)	383
Increase (decrease) in accounts payable and accrued expenses	(21)	554
Increase in payable to related party	164	189
Net cash provided by operating activities	11,512	52,179
Cash flows from investing activities:		
Purchase of Mortgage-backed securities and other securities	(371,178)	(931,007)
Purchase of securities underlying linked transactions		(66,704)
Proceeds from sale of Mortgage-backed securities and other securities	114,021	1,528,357
Principal payments and basis recovered on Mortgage-backed securities and other securities	55,483	79,493
Principal payments and basis recovered on securities underlying linked transactions	3,018	569
Payment of premium for option derivatives		(4,675)
Premium received from option derivatives		3,750
Net settlements of TBAs	2,370	601
Premium for interest rate swaptions, net		(1,000)
Net cash provided by (used in) investing activities	(196,286)	609,384
Cash flows from financing activities:		
Payment of offering costs		(67)
Proceeds from repurchase agreement borrowings	4,330,593	11,203,749
Proceeds from repurchase agreement borrowings underlying linked transactions	38,571	47,895

Repayments of repurchase agreement borrowings		(4,086,699)		(11,943,549)
Repayments of repurchase agreement borrowings underlying linked transactions		(87,044)		(4,025)
Repayment of cash overdraft				(5,666)
Due from counterparties		(2,387)		14,796
Due to counterparties		(31,848)		
Dividends on common stock		(19,445)		(27,041)
Net cash provided by (used in) financing activities		141,741		(713,908)
Net decrease in cash and cash equivalents		(43,033)		(52,345)
Cash and cash equivalents beginning of period		48,525		56,292
Cash and cash equivalents end of period	$	5,492	$	3,947
Supplemental disclosure of operating cash flow information:				
Interest paid	$	3,275	$	7,090
Supplemental disclosure of non-cash financing/investing activities:				
Principal payments of mortgage-backed securities, not settled	$	114	$	
Mortgage-backed securities sold, not settled	$	2,442	$	300,365
Mortgage-backed securities purchased, not settled	$	(104,526)	$	(219,704)
Mortgage-backed securities recorded upon unlinking of linked transactions	$	(62,435)	$	
Deferred offering costs payable	$	145	$	
Dividends and distributions declared, not paid	$	18,136	$	

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Notes to Financial Statements (Unaudited)

(in thousands-except share and per share data)

The following defines certain of the commonly used terms in these Notes to Financial Statements: Agency or Agencies refer to a federally chartered corporation, such as the Federal National Mortgage Association (Fannie Mae or FNMA) or the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), or an agency of the U.S. Government, such as the Government National Mortgage Association (Ginnie Mae or GNMA); references to MBS refer to mortgage backed securities, including residential mortgage-backed securities or RMBS , commercial mortgage-backed securities or CMBS , and Interest-Only Strips (as defined herein); Agency MBS refer to RMBS, CMBS and Interest-Only Strips issued or guaranteed by the Agencies while Non-Agency MBS refer to RMBS, CMBS and Interest-Only Strips that are not issued or guaranteed by the Agencies; references to ARMs refers to adjustable rate mortgages; references to Interest-Only Strips refer to interest-only (IO) and inverse interest-only (IIO) securities issued as part of or collateralized with MBS.

Note 1 Organization

Western Asset Mortgage Capital Corporation (is referred to throughout this report as the Company) is a real estate finance company that primarily invests in residential mortgage assets in the United States. Although the Company s core investment strategy is primarily focused on Agency RMBS, the Company has supplemented its portfolio with Non-Agency RMBS, Agency and Non-Agency CMBS and, under current market conditions, expects to increase its investment in Non-Agency RMBS and Agency and Non-Agency CMBS. In addition, the Company may opportunistically invest in asset-backed securities (ABS) as well.

The Company is externally managed by Western Asset Management Company (WAM , or the Manager), an investment advisor registered with the Securities and Exchange Commission (SEC). WAM is a wholly-owned subsidiary of Legg Mason, Inc. The Company operates and has elected to be taxed as a real estate investment trust or REIT commencing with its taxable year ended December 31, 2012.

Note 2 Summary of Significant Accounting Policies

Basis of Presentation

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to present fairly the Company s financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. These financial statements should be read in conjunction with the Company s annual report on Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission (SEC) on March 17, 2014. The results of operations for the period ended March 31, 2014 are not necessarily indicative of the results to be expected for the full year or any future period.

The Company currently operates as one business segment.

Cash and Cash Equivalents

The Company considers all highly-liquid short term investments with original maturities of 90 days or less when purchased to be cash equivalents. Cash and cash equivalents are exposed to concentrations of credit risk. The Company places its cash and cash equivalents with what it believes to be high credit quality institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit.

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Classification of mortgage-backed securities and valuations of financial instruments

Mortgage-backed and US Treasury securities - Fair value election

The Company has elected the fair value option for all of its MBS and US Treasury securities at the date of purchase, which permits the Company to measure these securities at fair value with the change in fair value included as a component of earnings. In the Manager s view, this election more appropriately reflects the results of the Company s operations for a particular reporting period, as financial asset fair value changes are presented in a manner consistent with the presentation and timing of the fair value changes of economic hedging instruments.

Balance Sheet Presentation

The Company s mortgage-backed securities purchases and sales are recorded on the trade date, which results in an investment related payable (receivable) for MBS purchased (sold) for which settlement has not taken place as of the balance sheet date. The Company s MBS are pledged as collateral against borrowings under repurchase agreements. Other than MBS which are accounted for as linked transactions, described below, the Company s MBS are included in Mortgage-backed securities at fair value and Investment related receivables on the Balance Sheet, with the fair value of such MBS pledged disclosed parenthetically.

Valuation of financial instruments

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable, for example, when there is little or no market activity for an investment at the end of the period, unobservable inputs may be used.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Transfers between levels are determined by the Company at the end of the reporting period.

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company consults with independent pricing services or obtains third party broker quotes. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayment and credit losses.

Valuation techniques for MBS may be based upon models that consider the estimated cash flows of the security. When applicable, the primary inputs to the model include yields for Agency To-Be-Announced securities (also known as TBAs), Agency MBS, the U.S. Treasury market and floating rate indices such as the London interbank offered rate or LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. To the extent, such inputs are observable and timely, these MBS are categorized as Level II of the fair value hierarchy; otherwise, unless alternative pricing information as described above is available, they are categorized as Level III.

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While linked transactions, described below, are treated as derivatives for GAAP, the securities underlying the Company s linked transactions are valued using similar techniques to those used for the Company s securities portfolio. The value of the underlying security is then netted against the carrying amount (which approximates fair value) of the repurchase agreement at the valuation date. Additionally, TBA instruments are similar in substance to the Company s Agency RMBS portfolio, and the Company therefore estimates fair value based on similar methods.

The Company determines the fair value of derivative financial instruments by obtaining quotes from a third party pricing service, whose pricing is subject to review by the Manager s pricing committee. In valuing its interest rate derivatives, such as swaps and swaptions, the Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. All of the Company s interest rate swaps are either cleared through a central clearing house and subject to the clearing house margin requirements or subject to bilateral collateral arrangements. The Company s agreements with its derivative counterparties also contain netting provisions; however the Company has elected to report the interest rate swaps on a gross basis. No credit valuation adjustment was made in determining the fair value of interest rate derivatives.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If the Company is forced to sell assets in a short period to meet liquidity needs, the prices it receives can be substantially less than their recorded fair values. Furthermore, the analysis of whether it is more likely than not that the Company will not be required to sell securities in an unrealized loss position before recovery of its amortized cost basis, the amount of such expected required sales, and the projected identification of which securities will be sold is also subject to significant judgment, particularly in times of market illiquidity.

Any changes to the valuation methodology will be reviewed by the Company and its Manager to ensure the changes are appropriate. As markets and products develop and the pricing for certain products becomes more transparent, the Company will continue to refine its valuation methodologies. The Company utilizes and follows the pricing methodology employed by its Manager, including its review and challenge process. The methods used by the Company may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company anticipates that its valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments can result in a different estimate of fair value at the reporting date. The Company uses inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

All valuations received from independent pricing services are non-binding. The Company primarily utilizes an independent third party pricing service as the primary source for valuing the Company s assets.

The Company generally receives one independent pricing service price for each investment in the Company s portfolio. The Manager has established a process to review and validate the pricing received from the independent pricing service and has a process for challenging prices received from the independent pricing service when necessary. The Company utilizes our Manager s policies in this regard. The Company s and the Manager s review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. The Manager s pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager s pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, our Manager generally challenges the independent pricing service price.

To ensure proper fair value hierarchy, The Company and the Manager review the methodology used by the third party pricing service to understand whether observable market data is being utilized in the vendor s pricing methodology. Generally, this review is conducted annually, however ad-hoc reviews of the pricing methodology and the data does occur. The review of the assumptive data received from the vendor includes comparing key inputs. In addition, as part of the Company s regular review of pricing, the Manager s pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination. The conclusion that a price should be overridden in accordance with the Manager s pricing methodology may impact the fair value hierarchy of the security for which such price has been adjusted.

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Interest income recognition and Impairment

Agency MBS and Non-Agency MBS, excluding Interest-Only Strips, rated AA and higher at the time of purchase

Interest income on mortgage-backed securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. Premiums and discounts associated with Agency MBS and Non-Agency MBS, excluding Interest-Only Strips, rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. The Company estimates prepayments at least quarterly for its securities and as a result, if prepayments increase (or are expected to increase), the Company will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) the Company will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

The Company assesses its Agency MBS and its Non-Agency MBS, excluding Interest-Only Strips, rated AA and higher at the time of purchase for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company s intent not to sell the security and whether it is more likely than not that Company will not be required to sell the security until recovery of its amortized cost basis. An other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company s Statement of Operations as Other loss on Mortgage-backed securities.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as the Company s estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Non-Agency MBS that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives

Interest income on Non-Agency MBS that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives are recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on the Company s observation of the then current information and events and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses (if applicable), and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the associated mortgage collateral,

periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

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Based on the projected cash flow of the Non-Agency MBS purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company s Statement of Operations as Other loss on Mortgage-backed securities.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as the Company s estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Certain of the Company s MBS that are in an unrealized loss position at March 31, 2014 are not considered other-than-temporarily impaired because the Company has no intent to sell these investments, it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis and the Company is not required to sell the security for regulatory or other reasons.

Sales of securities

Sales of securities are driven by the Company s portfolio management process. The Company seeks to mitigate risks including those associated with prepayments and will opportunistically rotate the portfolio into securities the Company s Manager believes have more favorable attributes. Strategies may also be employed to manage net capital gains, which need to be distributed for tax purposes. Realized gains or losses on sales of securities, including Agency Interest-Only Strips not characterized as derivatives, are included in the net Realized gain (loss) on sale of Mortgage-backed securities and other securities, net line item on the Statement of Operations, and are recorded at the time of disposition. Realized gains or losses on sales of securities which are part of a linked transaction are included in Gain (loss) on linked transactions, net while realized gains losses on Interest-Only Strips which are characterized as derivatives are included in Gain (loss) on derivative instruments, net line item in the Statement of Operations. The cost of positions sold is calculated using the specific identification method.

Securities in an unrealized loss position at the end of each reporting period are evaluated by the Company s Manager to determine whether the Company has the intent to sell such securities. To the extent the Company has no intent to sell such investments and it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis, such unrealized loss is included in Unrealized gain (loss) on Mortgage-backed securities and other securities, net in the Statement of Operations. Otherwise, when the Company has determined its intent to sell such securities, the unrealized loss is characterized as a realized loss and included in Other loss on Mortgage-backed securities on the Statement of Operations.

Due from counterparties/Due to counterparties

Due from counterparties represents cash posted by the Company with its counterparties as collateral for the Company s interest rate swaps and repurchase agreements. Due to counterparties represents cash posted with the Company by its counterparties as collateral under the Company s interest rate swaps, interest rate swaptions and repurchase agreements. To the extent the Company receives collateral other than cash from its counterparties such assets are not included in the Company s Balance Sheet. Notwithstanding the foregoing, if the Company either rehypothecates such assets or pledges the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability is reflected on the Balance Sheet.

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Derivatives and hedging activities

Subject to maintaining its qualification as a REIT for U.S. federal income tax purposes, the Company utilizes derivative financial instruments, including interest rate swaps, swaptions, futures contracts, TBAs and Agency and Non-Agency Interest-Only Strips to hedge the interest rate risk associated with its portfolio and related borrowings. Derivatives are used for hedging purposes rather than speculation. The Company determines the fair value of its derivative positions and obtains quotations from a third party to facilitate the process of determining these fair values. If the Company s hedging activities do not achieve the desired results, reported earnings may be adversely affected.

GAAP requires an entity to recognize all derivatives as either assets or liabilities and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives are classified as either hedges of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge) or hedges of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). Fair value adjustments are recorded in earnings immediately, if the Company does not elect hedge accounting for a derivative instrument.

The Company elected not to apply hedge accounting for its derivative instruments and records the change in fair value and net interest rate swap payments (including accrued amounts) related to interest rate swaps in Gain (loss) on derivative instruments, net in its Statement of Operations.

The Company also invests in Agency and Non-Agency Interest-Only Strips, swaptions, futures contracts and TBAs. The Company evaluates the terms and conditions of its holdings of Agency and Non-Agency Interest-Only Strips, swaptions, futures contracts and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Balance Sheet utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value. Accordingly, Agency and Non-Agency Interest-Only Strips, swaptions, futures contracts and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in its Statement of Operations, along with any interest earned (including accrued amounts). The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in Mortgage-backed securities on the Balance Sheet. The carrying value of swaptions, futures contracts and TBAs is included in Derivative assets or Derivative liabilities on the Balance Sheet.

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contact and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities, are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned (including accrued amounts) reported in the Gain (loss) on derivatives, net in the Statements of Operations. See Warrants below.

Repurchase agreements

Mortgage-backed securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on the Company s Balance Sheet as an asset and cash received from the lender are recorded in the Company s Balance Sheet as a liability, unless they are accounted for as linked transactions, described below. Interest paid in accordance with repurchase agreements is recorded as interest expense, unless they are accounted for as linked transactions, described below. The Company reflects all proceeds from repurchase agreement borrowings and repayment of repurchase agreement borrowings which are not linked transactions, including transactions pertaining to collateral received with respect to certain swap transactions, on a gross basis on the Statement of Cash Flows.

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Linked transactions

In instances where the Company acquires securities through repurchase agreements with the same counterparty from which the securities were purchased, the Company evaluates such transactions in accordance with GAAP. This guidance requires the initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another to be considered linked unless all of the criteria found in the guidance are met at the inception of the transaction. If the transaction meets all of the conditions, the initial transfer shall be accounted for separately from the repurchase financing, and the Company will record the securities and the related financing on a gross basis on its Balance Sheet with the corresponding interest income and interest expense in the Statements of Operations. If the transaction is determined to be linked, the Company will record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase securities as a derivative instrument with changes in market value being recorded on the Statement of Operations. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in Gain (loss) on linked transactions, net on its Statement of Operations. The Company refers to these transactions as Linked Transactions. When or if a transaction is no longer considered to be linked, the real estate security and related repurchase financing will be reported on a gross basis. The unlinking of a transaction causes a realized event in which the fair value of the real estate security as of the date of unlinking will become the cost basis of the real estate security. The difference between the fair value on the unlinking date and the existing cost basis of the security will be the realized gain or loss. Recognition of effective yield for such security will be calculated prospectively using the new cost basis. For linked transactions, the Company reflects purchases and sales of securities within the investing section of the Statement of Cash Flows. Proceeds from repurchase agreements borrowings and repayments of repurchase agreement borrowings are reflected in the financing section of the Statement of Cash Flows.

Share-based compensation

The Company accounts for share-based compensation to its independent directors, to its employees, to its Manager and to employees of its Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to the Company s independent directors including any such restricted stock which is subject to a deferred compensation program, and employees of the Company is measured at its fair value at the grant date, and amortized into expense over the service period on a straight-line basis. Compensation cost related to restricted common stock issued to the Manager and to employees of the Manager, including officers of the Company who are employees of the Manager, and its affiliates is initially measured at fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis and re-measured on subsequent dates to the extent the awards are unvested.

Warrants

For the Company s warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company s common stock in the private placement to certain accredited institutional investors on May 15, 2012, were evaluated by the Company and were recorded at their relative fair value as a component of equity at the date of issuance. See Derivatives and hedging activities above.

Income taxes

The Company operates and has elected to be taxed as a REIT commencing with its taxable year ended December 31, 2012. Accordingly, the Company will generally not be subject to corporate U.S. federal or state income tax to the extent that the Company makes qualifying distributions to stockholders, and provided that the Company satisfies, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the failure to qualify as a REIT could have a material adverse impact on the Company s results of operations and amounts available for distribution to stockholders.

The dividends paid deduction for qualifying dividends paid to stockholders is computed using the Company s taxable income as opposed to net income reported on the financial statements. Taxable income, generally, will differ from net income reported on the financial statements because the determination of taxable income is based on tax provisions and not GAAP.

The Company may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries (TRS). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes, and its value may not exceed 25% of the value of the Company. While a TRS will generate net income, a TRS can declare dividends to the Company, which will be included in the Company s taxable income and necessitate a distribution to its stockholders. Conversely, if the Company retains earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity. As of March 31, 2014, the Company did not have a TRS, or any other subsidiary.

The Company evaluates uncertain tax positions, if any, and classifies interest and penalties, if any, related to unrecognized tax benefits as a component of the provision for income taxes.

Offering costs

Offering costs borne by the Company in connection with the IPO and concurrent private placements completed on May 15, 2012 as well as its follow-on public stock offerings completed on October 3, 2012 and April 9, 2014 are, and will be, reflected as a reduction of additional paid-in-capital.

Earnings per share

GAAP requires use of the two-class method of computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity. The Company s participating securities are not allocated a share of the net loss as the participating securities do not have a contractual obligation to share in the net losses of the Company.

The remaining earnings are allocated to common stockholders and participating securities, to the extent that each security shares in earnings, as if all of the earnings for the period had been distributed. Each total is then divided by the applicable number of shares to arrive at basic earnings per share. For the diluted earnings, the denominator includes all outstanding common shares and all potential common shares assumed issued if they are dilutive. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of these potential common shares.

Comprehensive Income (Loss)

The Company has none of the components of comprehensive income (loss) and therefore comprehensive income (loss) is not presented.

Accounting standards applicable to emerging growth companies

The JOBS Act contains provisions that relax certain requirements for emerging growth companies , which includes the Company. For as long as the Company is an emerging growth company, which may be up to five full fiscal years, unlike other public companies, the Company will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor s attestation report on management s assessment of the effectiveness of the Company s system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012, unless the SEC determines otherwise.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. The Company intends to take advantage of such extended transition period. Since the Company will not be required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, its financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If the Company were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

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Recent accounting pronouncements

Accounting Standards to be Adopted in Future Periods

In April 2014, the Financial Accounting Standards Board issued updated guidance that changes the requirements for reporting discontinued operations. Under the new guidance, a discontinued operation is defined as a disposal of a component of an entity or group of components of an entity that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity s operations and financial results. The guidance is effective prospectively as of the first quarter of 2015, with early adoption permitted for new disposals or new classifications as held-for-sale. The guidance is effective for annual periods beginning on or after December 15, 2014 and interim periods within annual periods beginning on or after December 15, 2015. Early adoption is permitted but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue. The new guidance is not expected to have a material impact on the Company s financial statements.

Note 3 Fair Value of Financial Instruments

Fair Value Accounting Elections

The Company s MBS are designated as available-for-sale and the Company has elected the fair value option for all of its MBS, and as a result, all changes in the fair value of such securities are reflected in the results of operations.

Financial Instruments carried at Fair Value

The following tables present the Company s financial instruments carried at fair value as of March 31, 2014 and December 31, 2013, based upon the valuation hierarchy (dollars in thousands):

	March 31, 2014 Fair Value			
	Level I	Level II	Level III	Total
Assets				
Agency RMBS	$	$ 2,693,019	$	$ 2,693,019
Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS		110,330		110,330
Non-Agency RMBS		373,414	45,723	419,137
Agency and Non-Agency CMBS		14,590	10,718	25,308
Subtotal		3,191,353	56,441	3,247,794
Derivative assets	148	66,462	126	66,736
Non-Agency linked transactions		2,973		2,973

Total	$	148	$	3,260,788	$	56,567	$	3,317,503
Liabilities								
Derivative liabilities	$	30	$	20,723	$		$	20,753
Total	$	30	$	20,723	$		$	20,753

	December 31, 2013 Fair Value							
	Level I		Level II		Level III		Total	
Assets								
Agency RMBS	$		$	2,360,073	$		$	2,360,073
Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS				109,235				109,235
Non-Agency RMBS				352,056		6,152		358,208
Agency and Non-Agency CMBS				16,542		9,529		26,071
Subtotal				2,837,906		15,681		2,853,587
Derivative assets				105,826				105,826
Non-Agency linked transactions				18,559				18,559
Total	$		$	2,962,291	$	15,681	$	2,977,972
Liabilities								
Derivative liabilities	$		$	4,673	$		$	4,673
Total	$		$	4,673	$		$	4,673

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The following table presents additional information about the Company s financial instruments, which are measured at fair value on a recurring basis for which the Company has utilized Level III inputs to determine fair value:

	Mortgage-backed securities		Derivative assets	
$ in thousands	Three months ended March 31, 2014	Three months ended March 31, 2013	Three months ended March 31, 2014	Three months ended March 31, 2013
Beginning balance	$ 15,681	$	$	$
Transfers into Level III from Level II	19,468		126	
Transfers out Level III into Level II				
Purchases	19,854			
Sales and settlements				
Principal repayments				
Total net gains / (losses) included in net income				
Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net	1,514			
Premium and discount amortization, net	(76)			
Ending balance	$ 56,441	$	$ 126	$

There were three transfers between hierarchy levels during operations for the three months ended March 31, 2014. The assets which were transferred from Level II to Level III as of March 31, 2014, consisted of financial instruments for which there were no longer sufficient observable inputs to meet Level II criteria. Valuation for these assets was based on information received from a third party pricing service which utilized significant unobservable inputs. Accordingly, the Company determined that these assets should be classified as Level III assets.

The Company primarily utilizes an independent third party pricing services as the primary source for valuing the Company s assets. All valuations received from independent pricing services are non-binding. The Company generally receives one independent pricing service price for each investment in its portfolio. The Manager has established a process to review and validate the pricing received from the independent pricing service and has a process for challenging prices received from the independent pricing service when necessary. The Company utilizes its Manager s policies in this regard. The Company s and the Manager s review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. The Manager s pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager s pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price. To ensure proper fair value hierarchy, the Company and the Manager review the methodology used by the third party pricing service to understand whether observable market data is being utilized in the vendor s pricing methodology. Generally, this review is conducted annually, however ad-hoc reviews of the pricing methodology and the data does occur. In addition, as part of the Company s regular review of pricing, the Manager s pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination.

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Other Fair Value Disclosures

Due from counterparties and Due to counterparties on the Company s Balance Sheets are reflected at cost which approximates fair value.

The fair value of the repurchase agreements is based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best estimate current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies could have a material effect on the fair value amounts. At March 31, 2014, the Company s borrowings under repurchase agreements had a fair value of approximately $2.8 billion and a carrying value of approximately $2.8 billion and would be considered a Level II fair value measurement.

Note 4 Mortgage-Backed Securities

The following table presents certain information about the Company s investment portfolio aMarch 31, 2014 and December 31, 2013 (dollars in thousands)**.** Real estate securities that are accounted for as a component of linked transactions are not reflected in the tables set forth in this note. See Note 7 for further details.

	March 31, 2014						
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year Mortgage	$ 793,497	$ 45,224	$	$ 838,721	$ (23,761)	$ 814,960	3.5%
30-Year Mortgage	1,672,689	140,958		1,813,647	(103,752)	1,709,895	3.8%
Agency RMBS Interest-Only Strips	N/A	N/A	N/A	166,427	1,737	168,164	4.5%(2)
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A	N/A	N/A	N/A	110,330	3.3%(2)
Non-Agency RMBS	478,240	7,394	(96,217)	389,417	9,722	399,139	5.4%
Non-Agency RMBS Interest- Only Strips	N/A	N/A	N/A	19,322	676	19,998	5.6%
Agency and Non-Agency CMBS	27,239	(3,097)	(732)	23,410	1,898	25,308	3.8%
Total	$ 2,971,665	$ 190,479	$ (96,949)	3,250,944	$ (113,480)	$ 3,247,794	4.0%

	December 31, 2013						
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year Mortgage	$ 504,023	$ 28,498	$	$ 532,521	$ (29,595)	$ 502,926	3.2%
30-Year Mortgage	1,677,863	144,356		1,822,219	(127,981)	1,694,238	3.8%

Agency RMBS							
Interest-Only Strips	N/A	N/A	N/A	158,825	4,084	162,909	4.4%(2)
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A	N/A	N/A	N/A	109,235	4.6%(2)
Non-Agency RMBS	469,983	(47,224)	(79,898)	342,861	7,857	350,718	2.5%
Non-Agency RMBS Interest- Only Strips	N/A	N/A	N/A	7,420	70	7,490	5.2%
Agency and Non-Agency CMBS	11,979	(3,446)		8,533	996	9,529	1.6%
CMBS Interest-Only Strips	N/A	N/A	N/A	16,682	(140)	16,542	4.7%(2)
Total	$ 2,663,848	$ 122,184	$ (79,898)	$ 2,889,061	$ (144,709)	$ 2,853,587	3.6%

(1) Net weighted average coupon as of March 31, 2014 and December 31, 2013 is presented, net of servicing and other fees.

(2) Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and CMBS Interest-Only Strips have no principal balances and earn contractual interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.

(3) Interest on these securities is reported as a component of Gain (loss) on derivative instruments, net on the Statement of Operations.

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As of March 31, 2014 and December 31, 2013, the weighted average expected remaining term to the expected maturity of the investment portfolio, excluding linked transactions was 9.4 years and 8.5 years, respectively.

The components of the carrying value of the Company s investment portfolio are as follows:

	March 31, 2014	December 31, 2013
Principal balance	$ 2,971,665	$ 2,663,848
Amortized cost of Interest-Only Strips	185,749	182,927
Carrying value of Agency and Non-Agency Interest-Only Strips accounted for as derivatives	110,330	109,235
Unamortized premium	214,364	183,324
Unamortized discount	(23,885)	(61,140)
Discount designated as Credit Reserve and OTTI	(96,949)	(79,898)
Gross unrealized gains	20,982	19,798
Gross unrealized losses	(134,462)	(164,507)
Fair value	$ 3,247,794	$ 2,853,587

The following tables present the changes in the components of the Company s purchase discount and amortizable premium on its Non-Agency RMBS and Non-Agency CMBS for the three months ended March 31, 2014 and 2013 (dollars in thousands):

	Three months ended March 31, 2014		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Amortizable Premium
Balance at beginning of period	$ (79,898)	$ (71,295)	$ 20,625
Accretion of discount		5,256	
Amortization of premium			(3,469)
Realized credit losses	695		
Purchases	(19,727)	(5,681)	6,683
Sales	14,719	21,971	
Net impairment losses recognized in earnings	(477)		
Unlinking of Linked Transactions	(13,889)	(297)	32,132
Transfers/release of credit reserve	1,628	(3,870)	2,242
Balance of end of period	$ (96,949)	$ (53,916)	$ 58,213

(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

	Three months ended March 31, 2013		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Amortizable Premium
Balance at beginning of period	$ (12,659)	$ (5,523)	$ 12

Accretion of discount		771	
Amortization of premium			327
Realized credit losses	119		
Purchases	(107,415)	(25,423)	22,360
Sales			
Net impairment losses recognized in earnings			
Unlinking of Linked Transactions			
Transfers/release of credit reserve	(525)	420	105
Balance of end of period	$ (120,480)	$ (29,755)	$ 22,804

(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

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The following tables present the gross unrealized losses and estimated fair value of the Company s MBS by length of time that such securities have been in a continuous unrealized loss position at March 31, 2014 and December 31, 2013:

	March 31, 2014								
	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
20-Year Mortgage	$ 703,710	$ (17,057)	136	$ 111,250	$ (6,704)	9	$ 814,960	$ (23,761)	145
30-Year Mortgage	670,864	(37,833)	55	1,000,103	(66,222)	118	1,670,967	(104,055)	173
Agency Interest-Only Strips	65,502	(4,650)	12				65,502	(4,650)	12
Non-Agency RMBS	94,592	(1,887)	17				94,592	(1,887)	17
Agency and Non-Agency CMBS	14,549	(109)	8				14,549	(109)	8
Total	$ 1,549,217	$ (61,536)	228	$ 1,111,353	$ (72,926)	127	$ 2,660,570	$ (134,462)	355

	December 31, 2013								
	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
20-Year Mortgage	$ 395,979	$ (21,466)	52	$ 106,947	$ (8,129)	8	$ 502,926	$ (29,595)	60
30-Year Mortgage	1,242,871	(94,688)	151	439,811	(33,328)	26	1,682,682	(128,016)	177
Agency Interest-Only Strips	69,773	(4,210)	19				69,773	(4,210)	19
Non-Agency RMBS	104,706	(2,546)	18				104,706	(2,546)	18
Agency and Non-Agency CMBS	16,542	(140)	3				16,542	(140)	3
Total	$ 1,829,871	$ (123,050)	243	$ 546,758	$ (41,457)	34	$ 2,376,629	$ (164,507)	277

At March 31, 2014, the Company did not intend to sell any of its MBS that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these MBS before recovery of their amortized cost basis, which may be at their maturity.

The Company assesses its Agency MBS and Non-Agency MBS, excluding Interest-Only Strips, rated AA and higher at the time of purchase for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company s intent not to sell the security and that it is more likely than not that the Company will not be required to sell the security until recovery of its amortized cost. In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company s Statement of Operations as Other loss on Mortgage-backed securities.

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For Non-Agency MBS that rated below AA at the time of purchase and Agency and Non-Agency Interest-Only Strips, excluding Interest-Only Strips classified as derivatives, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. Other than for plain-vanilla variable rate Non-Agency MBS, the Company does not bifurcate the loss between credit loss and loss attributed to change in interest rates, therefore, the entire loss is recorded as other-than-temporary. These adjustments are reflected in the Company s Statement of Operations as Other loss on Mortgage-backed securities. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. If an other-than-temporary impairment is recognized as a result of this analysis, the yield is maintained at the current accretion rate. The last revised estimated cash flows are then used for future impairment analysis purposes. The Company s prepayment speed estimate is the primary assumption used to determine other-than temporary-impairments for Interest-Only Strips, excluding Agency and Non-Agency Interest-Only Strips accounted for as derivatives, for three months ended March 31, 2014 and 2013.

The Company recorded other-than-temporary-impairments for the three months ended March 31, 2014 of approximately $1.2 million and approximately $2.3 million for the three months ended March 31, 2013, respectively, for Agency IOs, Agency IIOs and 20-year Agency RMBS. The Company recorded approximately $477 thousand of other-than-temporary impairments for the three months ended March 31, 2014 and $0 for the three months ended March 31, 2013, respectively for Non-Agency MBS. The Company recorded no other-than-temporary-impairments for the three months ended March 31, 2014 and 2013 for CMBS Interest-Only Strips. Other-than-temporary-impairments are reported as Other loss on Mortgage-backed securities in the Company s Statement of Operations.

The following tables present components of interest income on the Company s MBS (dollars in thousands).

	For the three months ended March 31, 2014		
	Coupon Interest	**Net (Premium Amortization/ Amortization Basis) Discount Amortization**	**Interest Income**
Agency RMBS	$ 29,774	$ (12,063)	$ 17,711
Non-Agency RMBS	4,757	738	5,495
Agency and Non-Agency CMBS	47	177	224
Total	$ 34,578	$ (11,148)	$ 23,430

	For three months ended March 31, 2013		
	Coupon Interest	**Net (Premium Amortization/ Amortization Basis) Discount Amortization**	**Interest Income**
Agency RMBS	$ 50,519	$ (18,349)	$ 32,170
Non-Agency RMBS	482	1,098	1,580
Total	$ 51,001	$ (17,251)	$ 33,750

The following tables present the sales of the Company s MBS (dollars in thousands):

	For the three months ended March 31, 2014			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	$ 13,287	$ 16	$ (869)	$ (853)
Non-Agency RMBS	103,176	4,235	(535)	3,700
Total	$ 116,463	$ 4,251	$ (1,404)	$ 2,847

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately $11.2 million and gross realized losses of $869 thousand.

	For the three months ended March 31, 2013			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	$ 1,828,722	$ 8,646	$ (20,405)	$ (11,759)
Total	$ 1,828,722	$ 8,646	$ (20,405)	$ (11,759)

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately $8.4 million and gross realized losses of $99 thousand.

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Note 5 Borrowings under Repurchase Agreements

As of March 31, 2014, the Company had master repurchase agreements with 20 counterparties. As of March 31, 2014, the Company had borrowings under repurchase agreements with 16 counterparties. The following tables summarize certain characteristics of the Company s repurchase agreements at March 31, 2014 and December 31, 2013 (dollars in thousands):

			March 31, 2014	
Securities Pledged		**Repurchase Agreement Borrowings**	**Weighted Average Interest Rate on Borrowings Outstanding at end of period**	**Weighted Average Remaining Maturity (days)**
Agency RMBS	$	2,529,527	0.39%	28
Non-Agency RMBS		279,142	1.69%	31
Agency and Non-Agency CMBS		14,292	1.43%	71
Total	$	2,822,961	0.52%	29

			December 31, 2013	
Securities Pledged		**Repurchase Agreement Borrowings**	**Weighted Average Interest Rate on Borrowings Outstanding at end of period**	**Weighted Average Remaining Maturity (days)**
Agency RMBS	$	2,331,276	0.43%	24
Non-Agency RMBS		230,247	1.71%	18
Agency and Non-Agency CMBS		17,544	1.33%	58
Total	$	2,579,067	0.55%	24

For the three months ended March 31, 2014, the Company had average borrowings under its repurchase agreements of approximately $2.6 billion, had a maximum month-end balance during the period of approximately $2.8 billion. The Company had accrued interest payable at March 31, 2014 of approximately $1.8 million. For the three months ended March 31, 2013, the Company had average borrowings under its repurchase agreements of approximately $4.6 billion, had a maximum month-end balance during the period of approximately $4.8 billion and accrued interest payable of approximately $1.5 million.

The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company s repurchase agreement borrowings are accounted for as secured borrowings when the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, and is referred to as a margin call. The inability of the Company to post adequate collateral for a margin call by the counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under the Company s repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have a material adverse effect on the Company s financial position, results of operations and cash flows. During 2013, the volatility in both the Agency and Non-Agency MBS markets necessitated the Company being required to post additional collateral with respect to its repurchase agreements. The Company was able to satisfy the requirement for incremental collateral by utilizing unpledged assets and cash on hand. In addition, during the second and third quarters of 2013, the Company also rehypothecated pledged U.S. Treasury securities it received from its interest rate swap counterparties as incremental collateral in order to generate additional

cash proceeds in order to satisfy such margin requirements. The maximum amount of repurchase borrowings for the rehypothecated securities was $130.7 million during the year ended December 31, 2013. At March 31, 2014 and December 31, 2013, the Company did not have any rehypothecated U.S. Treasury securities.

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Continued volatility in these markets may create additional stress on the overall liquidity of the Company due to the long-term nature of its assets and the short-term nature of its liabilities. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, the Company could be required to sell securities, possibly even at a loss, to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on the Company s financial position, results of operations and cash flows. All of the Company s repurchase agreement counterparties are either U.S. financial institutions or the U.S. broker-dealer subsidiaries of foreign financial institutions.

Further, if the Company is unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms it may have a material adverse effect on the Company s financial position, results of operations and cash flow, due to the long term nature of the Company s investments and relatively short-term maturities of the Company s repurchase agreements. The financial covenants of certain of the repurchase agreements require the Company to maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of the Company s portfolio.

At March 31, 2014, repurchase agreements collateralized by MBS had the following remaining maturities.

(dollars in thousands)		Balance
Overnight	$	4,439
1 to 29 days		1,788,511
30 to 59 days		802,457
60 to 89 days		167,668
90 to 119 days		51,219
Greater than or equal to 120 days		8,667
Total	$	2,822,961

As discussed in Note 2, for any transactions determined to be linked, the initial transfer and repurchase financing will be recorded as a forward commitment to purchase assets. At March 31, 2014, the Company had repurchase agreements of approximately $12.7 million that were accounted for as linked transactions. At December 31, 2013, the Company had repurchase agreements of approximately $61.2 million that were accounted for as linked transactions. Linked repurchase agreements are not included in the tables above. See Note 7 for details.

At March 31, 2014, the following table reflects amounts of collateral at risk under its repurchase agreements greater than 10% of the Company s equity with any counterparty, including linked transactions.

	March 31, 2014 (dollars in thousands)			
Counterparty		Amount Collateral at Risk, at fair value	Weighted Average Remaining Maturity (days)	Percentage of Stockholders Equity
Barclays Capital Inc.	$	80,151	16	20.9%
Credit Suisse Securities (USA) LLC		55,763	24	15.3%

Note 6 Collateral Positions

The following tables summarize the Company s collateral positions, with respect to its borrowings under repurchase agreements, derivatives and clearing margin accounts at March 31, 2014 and December 31, 2013 (dollars in thousands):

	March 31, 2014		
	Assets Pledged- Fair Value	Accrued Interest	Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	$ 2,691,645	$ 11,060	$ 2,702,705
Non-Agency RMBS	392,032	893	392,925
Agency and Non-Agency CMBS	19,172	101	19,273
Cash (1)	11,074		11,074
Cash collateral for derivatives (1):	46,747		46,747
Total	$ 3,160,670	$ 12,054	$ 3,172,724

	December 31, 2013		
	Assets Pledged- Fair Value	Accrued Interest	Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	$ 2,463,347	$ 10,453	$ 2,473,800
Non-Agency RMBS	332,003	443	332,446
Agency and Non-Agency CMBS	23,597	159	23,756
Cash (1)	32,597		32,597
Cash collateral for derivatives (1):	22,837		22,837
Total	$ 2,874,381	$ 11,055	$ 2,885,436

(1) Cash posted as collateral is included in Due from counterparties on the Company s Balance Sheets.

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A reduction in the value of pledged assets typically results in the repurchase agreement counterparties, derivative counterparties and clearing margin counterparties initiating a daily margin call. At March 31, 2014 and December 31, 2013, MBS held by counterparties as security for repurchase agreements totaled approximately $3.1 billion and approximately $2.8 billion, respectively. Cash collateral held by counterparties at March 31, 2014 and December 31, 2013 was approximately $57.8 million and $55.4 million, respectively. Cash posted by counterparties at March 31, 2014 and December 31, 2013, was approximately $34.0 million and $65.9, respectively.

Note 7 Derivative Instruments

The Company s derivatives currently include interest rate swaps (interest rate swaps), interest rate swaptions, futures contracts, TBAs, linked transactions, Agency and Non-Agency Interest-Only Strips that are classified as derivatives, and options.

Interest rate swaps and interest rate swaptions

The Company is exposed to certain risks arising from both its business operations and economic conditions. Specifically, the Company s primary source of debt funding is repurchase agreements and the Company enters into derivative financial instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates, the Company enters into interest rate swap agreements which help to mitigate the volatility in the interest rate exposures and their related cash flows. Interest rate swaps generally involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. Notwithstanding the foregoing, in order to manage its hedge position with regard to its liabilities, the Company on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. The Company also enters into interest rate swaptions to help mitigate the effects of increases in interest rates on a portion of its borrowings under repurchase agreements. Interest rate swaptions provide the Company the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future.

While the Company has not elected to account for its interest rate swap derivative instruments as hedges under GAAP, it does not use interest rate swaps and swaptions for speculative purposes, but rather uses such instruments to manage interest rate risk and views them as economic hedges. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in earnings together with periodic net interest settlement amounts.

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The Company s interest rate swaps, interest rate swaptions, futures contracts, TBA derivative instruments and linked transactions consisted of the following at March 31, 2014 and December 31, 2013 (dollars in thousands):

			March 31, 2014		
Derivative Instrument	Designation	Balance Sheet Location	Notional Amount	Fair Value, excluding accrued interest	Accrued Interest Payable
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	$ 2,267,450	$ 64,246	$ 2,419
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	2,200,000	1,588	
Futures contract, assets	Non-Hedge	Derivative asset, at fair value	592,000	148	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	467,000	754	
Total derivative instruments, assets			5,526,450	66,736	2,419
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	2,332,400	(18,330)	3,959
Interest rate swaptions, liability	Non-Hedge	Derivative liability, at fair value	100,000		
Futures contract, liability	Non-Hedge	Derivative asset, at fair value	592,000	(30)	
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	813,000	(2,393)	
Total derivative instruments, liabilities			3,837,400	(20,753)	3,959
Linked transactions (1)	Non-Hedge	Linked transactions, net, at fair value	9,840	2,973	(43)
Total derivative instruments			$ 9,373,690	$ 48,956	$ 6,335

(1) Notional amount represents the current face of the securities comprising the linked transactions.

			December 31, 2013		
Derivative Instrument	Designation	Balance Sheet Location	Notional Amount	Fair Value, excluding accrued interest	Accrued Interest Payable
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	$ 2,135,950	$ 94,614	$ 9,994
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	2,200,000	11,177	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	13,600	35	
Total derivative instruments, assets			4,349,550	105,826	9,994
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	678,900	(3,202)	(26)
Interest rate swaptions, liability	Non-Hedge	Derivative liability, at fair value	100,000	(264)	
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	176,400	(1,207)	
Total derivative instruments, liabilities			955,300	(4,673)	(26)
Linked transactions (1)	Non-Hedge	Linked transactions, net, at fair value	56,028	18,559	(207)
Total derivative instruments			$ 5,360,878	$ 119,712	$ 9,761

(1) Notional amount represents the current face of the securities comprising the linked transactions.

The following tables summarize the average fixed pay rate and average maturity for the Company s interest rate swaps as of March 31, 2014 and December 31, 2013 (excludes interest rate swaptions) (dollars in thousands):

	March 31, 2014			
Remaining Interest Rate interest rate swap Term	**Notional Amount**	**Average Fixed Pay Rate**	**Average Maturity (Years)**	**Forward Starting**
1 year or less	$ 215,900	0.4%	0.6	%
Greater than 1 year and less than 3 years	729,100	0.5	1.9	
Greater than 3 years and less than 5 years	1,104,800	1.5	4.5	
Greater than 5 years	2,023,050	2.7	10.9	32.3
Total	$ 4,072,850	1.9%	7.0	16.1%

	December 31, 2013			
Remaining Interest Rate interest rate swap Term	**Notional Amount**	**Average Fixed Pay Rate**	**Average Maturity (Years)**	**Forward Starting**
1 year or less	$ 215,900	0.4%	0.8	%
Greater than 1 year and less than 3 years	179,100	0.5	1.9	
Greater than 3 years and less than 5 years	574,200	1.3	4.4	
Greater than 5 years	1,718,650	2.4	10.8	28.6
Total	$ 2,687,850	1.9%	8.0	18.3%

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The following tables summarize the average variable pay rate and average maturity for the Company s interest rate swaps as of March 31, 2014 and December 31, 2013 (excludes interest rate swaptions) (dollars in thousands):

	March 31, 2014			
Remaining Interest Rate interest rate swap Term	**Notional Amount**	**Average Variable Pay Rate**	**Average Maturity (Years)**	**Forward Starting**
Greater than 3 years and less than 5 years	$ 281,000	0.2%	4.9	%
Greater than 5 years	246,000	0.2	12.5	
Total	$ 527,000	0.2%	8.4	%

	December 31, 2013			
Remaining Interest Rate interest rate swap Term	**Notional Amount**	**Average Variable Pay Rate**	**Average Maturity (Years)**	**Forward Starting**
Greater than 3 years and less than 5 years	$ 81,000	0.2%	4.8	%
Greater than 5 years	46,000	0.2	24.1	
Total	$ 127,000	0.2%	11.8	%

The Company s agreements with certain of its bilateral interest rate swap counterparties may be terminated at the option of the counterparty if the Company does not maintain certain equity and leverage metrics, the most restrictive of which contain provisions which become more restrictive based upon portfolio composition. Through March 31, 2014, the Company was in compliance with the terms of such financial tests.

At March 31, 2014, the Company had entered into six swaptions with notional amounts ranging from $100.0 million to $1.5 billion which expire between May 1, 2014 and October 28, 2014. If exercised, the Company can enter into seven year and ten year fixed pay swap agreement with a fixed pay rate between 2.74% and 3.73%. At March 31, 2014, the Company had also entered into a swaption with a notional amount of $100.0 million that expires in May 1, 2014. If exercised, the Company can enter into a ten-year variable pay swap agreement with a fixed receive rate of 3.98%.

The Company has minimum collateral posting thresholds with certain of its derivative counterparties, including with its clearing broker for cleared swaps, for which it typically pledges cash. As of March 31, 2014 and December 31, 2013, the Company had cash pledged as collateral of approximately $46.7 million and $22.8 million, respectively, which is reported on the Balance Sheet as Due from counterparties. The Company received cash of approximately $29.5 million and $62.7 as collateral against derivatives at March 31, 2014 and December 31, 2013, respectively, which is reported on the Balance Sheet as Due to counterparties. As of March 31, 2014, the Company has swaps with two counterparties that are based in England and Switzerland, with fair values in an asset position of approximately $13.0 million and $25.2 million and notional balances of $321.8 million and $825.1 million, respectively. At December 31, 2013, the Company had swaps with fair values in an asset position of $19.4 million and $34.2 million and notional balances of $321.8 million and $825.1 million with these two counterparties. Included in the $29.5 million and $62.7 million received by the Company is cash posted as collateral by these two counterparties of approximately $23.0 and $42.7 million at March 31, 2014 and December 31, 2013, respectively.

Interest-Only Strips

The Company also invests in Interest-Only Strips. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Balance Sheet utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value with changes recognized in Gain (loss) on derivative instruments, net in the Statement of Operations, along with any interest received. The carrying value of these Interest-Only Strips is included in Mortgage-backed securities on the Balance Sheet.

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To-be-announced securities

The Company also purchased or sold TBAs. As of March 31, 2014 and December 31, 2013, the Company had contracts to purchase (long position) and sell (short position) TBAs on a forward basis. Following is a summary of the Company s long and short TBA positions reported in Derivative assets, at fair value on the Balance Sheet as of March 31, 2014 and December 31, 2013 (dollars in thousands):

	March 31, 2014		December 31, 2013	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Purchase contracts, asset	$ 250,000	$ 195	$ 13,600	$ 35
Sale contracts, asset	(217,000)	559		
TBA securities, asset	33,000	754	13,600	35
Purchase contracts, liability	540,000	(1,816)	176,400	(1,207)
Sale contracts, liability	(273,000)	(577)		
TBA securities, liability	267,000	(2,393)	176,400	(1,207)
TBA securities, net	$ 300,000	$ (1,639)	$ 190,000	$ (1,172)

The following table presents additional information about the Company s contracts to purchase and sell TBAs for the three months ended March 31, 2014 (dollars in thousands):

	Notional Amount as of December 31, 2013	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of March 31, 2014
Purchase of TBAs	$ 190,000	1,970,000	$ (1,370,000)	$ 790,000
Sale of TBAs	$	1,860,000	$ (1,370,000)	$ 490,000

Futures Contracts

The Company also entered into Eurodollar futures during the three months ended March 31, 2014. As of March 31, 2014, the Company had purchase contracts (long position), representing a notional amount of $592.0 million with an expiration date of June 2016. In addition, as of March 31, 2014, the Company had contracts to sell (short position), representing a notional amount of $592.0 million with an expiration date of June 2018.

Gain (loss) on derivative instruments

The below table summarizes the effect of interest rate swaps, swaptions, options, futures contracts, Agency and Non-Agency Interest-Only Strips as derivatives and TBAs reported in Gain (loss) on derivative instruments, net on our Statement of Operations for the three months ended March 31, 2014 and 2013 (dollars in thousands):

	Three months ended March 31, 2014				
Description	**Realized Gain (Loss), net**	**Contractual interest income (expense), net(1)**	**Basis Recovery**	**Mark-to-market adjustments**	**Total**
Interest rate swaps	$ 2	$ (7,853)	$	$ (45,496)	$ (53,347)
Interest rate swaptions				(9,324)	(9,324)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(869)	8,426	(5,592)	(1,220)	745
Futures contracts				118	118
TBAs	2,370			(468)	1,902
Total	$ 1,503	$ 573	$ (5,592)	$ (56,390)	$ (59,906)

	Three months ended March 31, 2013				
Description	**Realized Gain (Loss), net**	**Contractual interest income (expense), net(1)**	**Basis Recovery**	**Mark-to-market adjustments**	**Total**
Interest rate swaps	$ 18,258	$ (4,582)	$	$ 1,858	$ 15,534
Interest rate swaptions				(1,506)	(1,506)
Agency Interest-Only Strips accounted for as derivatives	(99)	5,943	(4,185)	(2,348)	(689)
Options				(324)	(324)
TBAs	601			1,224	1,825
Total	$ 18,760	$ 1,361	$ (4,185)	$ (1,096)	$ 14,840

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received.

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Linked Transactions

As discussed in Note 2, when the initial transfer of a financial asset and repurchase financing are entered into contemporaneously with, or in contemplation of, one another, the transaction will be considered linked unless all of the criteria found in the applicable accounting guidance are met at the inception of the transaction. If the transaction is determined to be linked, the Company records the initial transfer and repurchase financing on a net basis and records a forward commitment to purchase assets as a derivative instrument with changes in market value being recorded in the Gain (loss) on linked transactions, net on the Statement of Operations. While linked transactions are treated as derivatives for GAAP, the fair value of linked transactions reflects the value of the underlying security s fair market value netted with the respective linked repurchase agreement borrowings.

The following table presents certain information related to the securities and repurchase agreements accounted for as part of linked transaction which is reported in Linked transactions, net, at fair value on the Balance Sheet at March 31, 2014, and Gain (loss) on linked transactions, net on the Statement of Operations for the three months ended March 31, 2014 and 2013 (dollars in thousands):

	For the three months ended March 31, 2014						
Instrument	**Fair Value(2)**	**Net Interest Income(1) (Expense)**	**Mark-to-market adjustments on linked transactions**	**Net Realized Gain (loss)**	**Gain (loss) on linked transactions, net**	**Weighted Average Coupon / Cost of Funds(2)**	**Weighted Average Life (years)/ Weighted Average days to Maturity(2)**
Non-Agency RMBS	$ 15,687	$ 928	$ 226	$ 1,290	$ 2,444	31.1%	10.5 years
Non-Agency Repurchase Agreement	(12,714)	(225)			(225)	1.56%	17 days
Linked transactions, net, at fair value	$ 2,973	$ 703	$ 226	$ 1,290	$ 2,219	n/a	n/a

(1) Net interest income includes amortization of premium of approximately $2.2 million for Non-Agency RMBS.

(2) Includes information only for linked transactions at March 31, 2014.

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Non-Agency RMBS	$ 66,715	$ 435	$ 250	$	$ 685	0.8%	6.7 years
[illegible]							
Linked transactions, net, at fair value	$ 22,844	$ 346	$ 250	$	$ 596	n/a	n/a

(1) Net interest income includes accretion of discount of $329 thousand for Non-Agency RMBS.

(2) Includes information only for linked transactions at March 31, 2013.

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At March 31, 2014, the Company pledged MBS accounted for as linked transactions with a fair value of approximately $15.7 million as collateral for the related linked repurchase agreements. The Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events.

Note 8 Offsetting Assets and Liabilities

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset on the Company s Balance Sheets at March 31, 2014 and December 31, 2013:

Offsetting of Derivative Assets

As of March 31, 2014

$s in thousands Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		Net Amount
				Financial Instruments (1)	Cash Collateral Received	
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives included in MBS	$ 110,330	$	$ 110,330	$ (98,087)	$	$ 12,243
Derivative asset, at fair value	66,736		66,736	(8,217)	(29,380)	29,139
Linked transactions, net, at fair value	15,687	(12,714)	2,973			2,973
Total	$ 192,753	$ (12,714)	$ 180,039	$ (106,304)	$ (29,380)	$ 44,355

Offsetting of Derivative Liabilities and Repurchase agreements

As of March 31, 2014

Gross	Gross	Net Amounts of Liabilities	Gross Amounts Not Offset in the Balance Sheet	Net Amount

$s in thousands Description	**Amounts of Recognized Liabilities**	**Amounts Offset in the Balance Sheet**	**presented in the Balance Sheet**	**Financial Instruments (1)**	**Cash Collateral Pledged(1)**	
Derivative liability, at fair value(2)	$ 20,753	$	$ 20,753	$ (8,217)	$ (10,838)	$ 1,698
Repurchase Agreements(3)	2,822,961		2,822,961	(2,822,961)		
	$ 2,843,714	$	$ 2,843,714	$ (2,831,178)	$ (10,838)	$ 1,698

(1) Amounts disclosed in the Financial Instruments column of the table above represent securities collateral pledged that is available to be offset against liability balances associated with repurchase agreement and derivative transactions. Amounts disclosed in the Cash Collateral Pledged column of the table above represents amounts pledged as collateral against derivative transactions.

(2) Cash collateral pledged against the Company s derivative counterparties was approximately $46.7 million as of March 31, 2014.

(3) The fair value of securities pledged against the Company s repurchase agreements was approximately $3.1 billion as of March 31, 2014.

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Offsetting of Derivative Assets

As of December 31, 2013

Agency and Non-Agency Interest-Only Strips, accounted for as derivatives included in MBS	$ 109,235	$	$ 109,235	$ (109,235)	$	$
Linked transactions, net, at fair value	79,746	(61,187)	18,859			18,559

Offsetting of Derivative Liabilities and Repurchase agreements

As of December 31, 2013

Derivative liability, at fair value(2)	$ 4,673	$	$ 4,673	$ (3,501)	$	$ 1,172
	$ 2,583,740	$	$ 2,583,740	$ (2,582,568)	$	$ 1,172

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(1) Amounts disclosed in the Financial Instruments column of the table above represent securities collateral pledged that is available to be offset against liability balances associated with repurchase agreement and derivative transactions. Amounts disclosed in the Cash Collateral Pledged column of the table above represents amounts pledged as collateral against derivative transactions.

(2) Cash collateral pledged against the Company s Swaps was approximately $22.8 million as of December 31, 2013.

(3) The fair value of securities pledged against the Company s repurchase agreements was approximately $2.8 billion as of December 31, 2013.

Certain of the Company s repurchase agreement and derivative transactions are governed by underlying agreements that generally provide for a right of setoff in the event of default or in the event of a bankruptcy of either party to the transaction.

Note 9 Related Party Transactions

Management Agreement

In connection with the Company s IPO in May 2012, the Company entered into a management agreement (the Management Agreement) with the Manager, which describes the services to be provided by the Manager and compensation for such services. The Manager is responsible for managing the Company s operations, including: (i) performing all of its day-to-day functions; (ii) determining investment criteria in conjunction with the board of directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of the Company s board of directors. Pursuant to the terms of the Management Agreement, the Manager is paid a management fee equal to 1.50% per annum of the Company s stockholders equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders equity means the sum of the net proceeds from any issuances of the Company s equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of the Company s shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges included in other loss on MBS, unrealized gain (loss) on MBS and other securities and non-cash portion of gain (loss) on derivative instruments, that have impacted stockholder s equity as reported in the Company s financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company s independent directors and after approval by a majority of the Company s independent directors. However, if the Company s stockholders equity for any given quarter is negative based on the calculation described above, the Manager will not be entitled to receive any management fee for that quarter.

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In addition, the Company may be required to reimburse the Manager for certain expenses as described below, and shall reimburse for the compensation paid to the Company s CFO. Expense reimbursements to the Manager are made in cash on a monthly basis following the end of each month. The Company s reimbursement obligation is not subject to any dollar limitation. Because the Manager s personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, the Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm s-length basis.

The Management Agreement may be amended, supplemented or modified by agreement between the Company and the Manager. The initial term of the Management Agreement expires on May 15, 2015 and it is automatically renewed for one-year terms on each anniversary thereafter unless previously terminated as described below. The Company s independent directors will review the Manager s performance and any fees payable to the Manager annually and, following the initial term, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds of the Company s independent directors, based upon: (i) the Manager s unsatisfactory performance that is materially detrimental to the Company; or (ii) the Company s determination that any fees payable to the Manager are not fair, subject to the Manager s right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds (2/3) of the Company s independent directors. The Company will provide the Manager 180 days prior notice of any such termination. Unless terminated for cause, the Company will pay the Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

The Company may also terminate the Management Agreement at any time, including during the initial term, without the payment of any termination fee, with 30 days prior written notice from the Company s board of directors for cause, which will be determined by a majority of the Company s independent directors, which is defined as: (i) the Manager s continued material breach of any provision of the Management Agreement (including the Manager s failure to comply with the Company s investment guidelines); (ii) the Manager s fraud, misappropriation of funds, or embezzlement against the Company; (iii) the Manager s gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of the Manager, including an order for relief in an involuntary bankruptcy case or the Manager authorizing or filing a voluntary bankruptcy petition; (v) the Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of the Manager.

For the three months ended March 31, 2014 and 2013, the Company incurred approximately $1.8 million and approximately $2.1 million in management fees, respectively.

In addition to the management fee, the Company is also responsible for reimbursing the Manager for certain expenses paid by the Manager on behalf of the Company and for certain services provided by the Manager to the Company. For the three months ended March 31, 2014 and 2013, the Company recorded expenses included in general and administrative expense totaling approximately $210 thousand and approximately $9 thousand, respectively related to employee costs and benefits associated with the Company s sole employee paid by the Manager on behalf of the Company. As of January 1, 2014, the aforementioned employee became an employee of the Manager and going forward the Company will reimburse the Manager for such employee s compensation including employee benefits. Any such expenses incurred by the Manager and reimbursed by the Company, including the employee compensation expense discussed above, are typically included in the Company s general and administrative expense on its Statement of Operations, or may be reflected on the Balance Sheet and associated statement of changes in stockholders equity, based on the nature of the item. At March 31, 2014 and December 31, 2013, approximately $1.8 million and approximately $1.8 million, respectively for management fees incurred but not yet paid was included in payable to related party on the Balance Sheet. In addition, at March 31, 2014 and December 31, 2013, approximately $202 thousand and $0, respectively of costs incurred but not yet paid was included in payable to related party on the Balance Sheet.

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Note 10 Share-Based Payments

In conjunction with the Company s IPO and concurrent private placement, the Company s board of directors approved the Western Asset Mortgage Capital Corporation Equity Plan (the Equity Plan) and the Western Asset Manager Equity Plan (the Manager Equity Plan and collectively the Equity Incentive Plans).

On May 15, 2012, the Company granted 51,159 shares of restricted common stock to the Manager under the Manager Equity Plan that is equal to 0.5% of the aggregate number of shares of common stock sold in the IPO and units sold in the concurrent private placement to certain institutional accredited investors. One-third of these restricted shares vested on May 15, 2013, the first anniversary of the grant date and one-third will vest on each of the second and third anniversaries of the grant date.

On May 15, 2012, the Company granted a total of 4,500 shares (1,500 each) of restricted common stock under the Equity Plan to the Company s three independent directors. These restricted shares vested in full on May 15, 2013, the first anniversary of the grant date.

On June 25, 2012, the Company granted 10,455 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these restricted shares vested on January 1, 2013, one-third vested on January 1, 2014 and the remaining one-third will vest on January 1, 2015.

On March 1, 2013, the Company granted a total of 150,000 shares of restricted common stock to the Manager under the Manager Equity Plan. One-third of these shares vested on March 1, 2014 and one third will vest on each of the second and third anniversaries of the grant date.

On March 1, 2013, the Company granted 10,559 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these restricted shares vested on January 1, 2014, one-third will vest on January 1, 2015 and the remaining one-third will vest on January 1, 2016.

On June 10, 2013, the Company granted a total of 4,887 (1,629 each) of restricted common stock under the Equity Plan to the Company s three independent directors. These restricted shares will vest in full on the first anniversary of the grant date. Each of the independent directors has elected to defer the shares granted to him under the Company s Director Deferred Fee Plan (the Director Deferred Fee Plan). The Director Deferred Fee Plan permits eligible members of the Company s board of directors to defer certain stock awards made under its director compensation programs. The Director Deferred Fee Plan allows directors to defer issuance of their stock awards and therefore defer payment of any tax liability until the deferral is terminated, pursuant to the election form executed each year by each eligible director.

On March 12, 2014, the Company granted 200,000 shares of restricted common stock to the Manager under the Manager Equity Plan. One-third of these shares will vest on March 1, 2015, one-third will vest on March 1, 2016 and the remaining one-third will vest on March 1, 2017.

On March 12, 2014, the Company granted 15,180 shares of restricted common stock to its chief financial officer under the Equity Plan. One-third of these shares will vest on January 1, 2015, one-third will vest on January 1, 2016 and the remaining one-third will vest on January 1, 2017.

The Equity Incentive Plans include provisions for grants of restricted common stock and other equity-based awards to the Manager, its employees and employees of its affiliates and to the Company s directors, officers and employees. The Company can issue up to 3.0% of the total number of issued and outstanding shares of its common stock (on a fully diluted basis) at the time of each award (other than any shares previously issued or subject to awards made pursuant to one of the Company s Equity Incentive Plans) under these Equity Incentive Plans. At May 15, 2012, there were 308,335 shares of common stock initially reserved for issuance under the Equity Incentive Plans. Upon the completion of the October 3, 2012 follow-on common stock offering and the stock portion of the Company s dividend declared December 19, 2013, the number of shares of common stock available for issuance under the Equity Incentive Plans increased to 798,211, inclusive of the 446,740 shares of restricted stock issued as provided above and 20,965 shares of restricted stock issued as a result of the stock portion of the dividend declared on December 19, 2013 and restricted stock attributed to dividends on restricted stock under the Director Deferred Fee Plan. The Company recognized stock-based compensation expense of approximately $588 thousand and approximately $286 thousand for the three months ended March 31, 2014 and 2013, respectively and had unamortized compensation expense of $18 thousand for equity awards and approximately $6.3 million for liability awards and $538 thousand for equity awards and approximately $3.8 million for liability awards at March 31, 2014 and 2013, respectively.

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All restricted common shares granted, other than those whose issuance has been deferred pursuant the Director Deferred Fee Plan, possess all incidents of ownership, including the right to receive dividends and distributions currently, and the right to vote. Dividend equivalent payments otherwise allocable to restricted common shares under the Deferred Compensation Plan are deemed to purchase additional phantom shares of the Company s common stock that are credited to each participant s deferral account. The award agreements include restrictions whereby the restricted shares cannot be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of prior to the lapse of restrictions under the respective award agreement. The restrictions lapse on the unvested restricted shares awarded when vested, subject to the grantee s continuing to provide services to the Company as of the vesting date. Unvested restricted shares and rights to dividends thereon are forfeited upon termination of the grantee.

The following is a summary of restricted common stock vesting dates as of March 31, 2014 and December 31, 2013, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

Vesting Date	**March 31, 2014 Shares Vesting**	**December 31, 2013 Shares Vesting**
January 2014		7,685
March 2014		54,852
May 2014	18,708	18,707
June 2014	6,287	6,279
January 2015	12,745	7,685
March 2015	121,518	54,852
May 2015	18,708	18,707
January 2016	8,920	3,860
March 2016	121,518	54,852
January 2017	5,060	
March 2017	66,667	
	380,131	227,479

The following table presents information with respect to the Company s restricted stock for the three months ended March 31, 2014 including shares whose issuance has been deferred under the Director Deferred Fee Plan:

	Shares of Restricted Stock	**Weighted Average Grant Date Fair Value (1)**
Outstanding at beginning of period	252,517	$ 20.34
Granted	215,188	16.47
Cancelled/forfeited		
Outstanding at end of year	467,705	$ 18.56
Unvested at end of year	380,131	$ 18.19

(1) The grant date fair value of restricted stock awards is based on the closing market price of the Company s common stock at the grant date.

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Note 11 Shareholders Equity

On May 9, 2012, the Company entered into: (i) a binding underwriting agreement with a group of underwriters to sell 8.0 million shares of the Company s common stock for $20.00 per share for an aggregate offering price of $160.0 million; (ii) unit purchase agreements, pursuant to a private placement, with certain institutional accredited investors to sell 2,231,787 warrant units for $20.00 per unit for an aggregate offering price of approximately $44.6 million; and (iii) an agreement to sell 46,043 shares of the Company s common stock, for $20.00 per share to our Manager s deferred compensation plan in another private placement for an aggregate offering price of approximately $0.9 million.

Each of the aforementioned warrant units consists of one share of the Company s common stock and a warrant to purchase 0.5 of a share of the Company s common stock, subject to adjustment. At the time of issuance, each warrant had an exercise price of $20.50 per share, subject to adjustment upon the occurrence of customary events triggering an anti-dilution adjustment and certain sales of the Company s common stock (see discussion below). In addition, the warrants are subject to certain limitations on exercise. The warrants expire on May 15, 2019. On October 3, 2012, as a result of the follow-on offering the exercise price of the warrants was reduced from $20.50 to $19.44. In addition, on January 28, 2014, the exercise price was further reduced to $17.59, and the warrant shares purchasable increased to 1,232,916 as a result of the stock portion of the December 19, 2013 dividend which was paid on January 28, 2014.

The net proceeds to the Company from the IPO and two concurrent private placements were approximately $204.4 million, net of offering expenses of $1.2 million for which the Company agreed to be responsible. The Manager agreed to be responsible for all offering expenses in excess of $1.2 million, including the underwriting discount and the placement agent fees in the two private placements (in the aggregate, approximately $7.8 million).

On September 27, 2012, the Company entered into a binding agreement with a group of underwriters to sell an incremental 12.0 million shares of the Company s common stock, effective as of September 28, 2012, which closed on October 3, 2012. The agreement provided the underwriters with the right to purchase an additional 1.8 million shares (15% of 12.0 million) during the succeeding thirty (30) days. The shares were offered to the market at a price of $22.20 per share and the underwriters exercised their option to purchase the incremental 1.8 million shares on September 28, 2012. Net proceeds to the Company were approximately $301.0 million after subtracting underwriting commissions and offering expenses of approximately $4.8 million. In addition, the Company incurred other offering costs of approximately $559 thousand.

On December 19, 2013, the Company declared a dividend of $2.35 per common share payable in a combination of cash and stock. For stockholders who elected to receive the entire $2.35 per share dividend in stock, each stockholder received 0.1590 shares in newly issued common stock for each common share that they held as of the dividend record date. For stockholders who elected to receive the dividend in cash, or did not make an election, each stockholder received $0.9159 per share in cash and 0.0970 shares in newly issued common stock for each common share that they held as of the dividend record date. The dividend was paid on January 28, 2014 to shareholders of record as of December 30, 2013. As a result of a portion of the dividend being paid in stock, common shares of 2,548,784 where issued by the Company.

Note 12 Net Loss per Common Share

The table below presents basic and diluted net income (loss) per share of common stock using the two-class method for the three months ended March 31, 2014 and 2013 (dollars, other than shares and per share amounts, in thousands):

	For the three months ended March 31, 2014	For the three months ended March 31, 2013
Numerator:		
Net loss attributable to common stockholders and participating securities for basic and diluted earnings per share	$ (8,441)	$ (28,499)
Less:		
Dividends and undistributed earnings allocated to participating securities	168	
Net loss allocable to common stockholders basic and diluted	$ (8,609)	$ (28,499)
Denominator:		
Weighted average common shares outstanding for basic earnings per share	26,658,665	24,081,315
Weighted average diluted shares outstanding (stock awards)		
Weighted average diluted shares outstanding (warrants)		
Weighted average common shares outstanding for diluted earnings per share	26,658,665	24,081,315
Basic earnings per common share	$ (0.32)	$ (1.18)
Diluted earnings per common share	$ (0.32)	$ (1.18)

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The following potential common shares, which are securities or other contracts that may entitle its holder to obtain common shares, were excluded from diluted earnings per share for the three months ended March 31, 2013, since the Company had a net loss for the period and their inclusion would have been anti-dilutive: 121,357 related to warrants and 11,463 related to stock awards.

Note 13 Income Taxes

Based on the Company s analysis of any potential uncertain income tax positions, the Company concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria as of March 31, 2014. The Company files U.S. federal and state income tax returns. As of March 31, 2014, tax returns filed by the Company for 2012 are open for examination pursuant to relevant statutes of limitation. In the event that the Company incurs income tax related interest and penalties, the Company s policy is to classify them as a component of provision for income taxes.

Note 14 Contingencies

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any material contingencies at March 31, 2014.

Note 15 Subsequent Events

On April 9, 2014, the Company completed a follow-on public offering of 13,000,000 shares of its common stock and a private placement of 650,000 shares of its common stock with its Manager. The combined net proceeds from the public offering and private placement were approximately $200.0 million, after deducting the underwriting discount and estimated offering expenses payable by the Company. On May 2, 2014, underwriters from the April stock offering notified the Company that they had elected to exercise a portion of the overallotment option and purchase an additional 1,000,000 shares of common stock from the Company providing the Company with incremental proceeds of approximately $14.7 million, which were received on May 7, 2014.

As a result of the April 9, 2014 follow-on public offering of common stock, the exercise price of each of the outstanding warrants was reduced from $17.59 to $16.70.

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

FORWARD-LOOKING INFORMATION

The Company makes forward-looking statements herein and will make forward-looking statements in future filings with the Securities and Exchange Commission (the SEC), press releases or other written or oral communications within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). For these statements, the Company claims the protections of the safe harbor for forward-looking statements contained in such sections. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond the Company s control. These forward-looking statements include information about possible or assumed future results of the Company s business, financial condition, liquidity, results of operations, plans and objectives. When the Company uses the words believe, expect, anticipate, estimate, plan, continue, intend, should, may or similar expressions, the Company intends to identify forward-looking statements. Statem regarding the following subjects, among others, may be forward-looking: market trends in the Company s industry, interest rates, real estate values, the debt securities markets, the U.S. housing and commercial real estate markets or the general economy or the demand for residential and/or commercial mortgage loans; the Company s business and investment strategy; the Company s projected operating results; actions and initiatives of the U.S. Government and changes to U.S. Government policies and the execution and impact of these actions, initiatives and policies; the state of the U.S. economy generally or in specific geographic regions; economic trends and economic recoveries; the Company s ability to obtain and maintain financing arrangements, including securitizations; the current potential return dynamics available in residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS and collectively with RMBS, MBS); the level of government involvement in the U.S. mortgage market; the anticipated default rates on Agency and Non-Agency RMBS (as defined herein); the loss severity on Non-Agency RMBS; the return of the Non-Agency RMBS securitization market; the general volatility of the securities markets in which the Company participates; changes in the value of the Company s assets; the Company s expected portfolio of assets; the Company s expected investment and underwriting process; interest rate mismatches between the Company s target assets and any borrowings used to fund such assets; changes in interest rates and the market value of the Company s target assets; changes in prepayment rates on the Company s target assets; effects of hedging instruments on the Company s target assets; rates of default or decreased recovery rates on the Company s target assets; the degree to which the Company s hedging strategies may or may not protect the Company from interest rate volatility; impact of and changes in governmental regulations, tax law and rates, accounting guidance and similar matters; the Company s ability to maintain the Company s qualification as a real estate investment trust for U.S. federal income tax purposes; the Company s ability to maintain its exemption from registration under the Investment Company Act of 1940, as amended (the 1940 Act); the availability of opportunities to acquire Agency RMBS, Non-Agency RMBS, CMBS, residential and/or commercial mortgage loans and other mortgage assets; the availability of qualified personnel; estimates relating to the Company s ability to make distributions to its stockholders in the future; and the Company s understanding of its competition.

The forward-looking statements are based on the Company s beliefs, assumptions and expectations of its future performance, taking into account all information currently available to it. Forward-looking statements are not predictions of future events. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to the Company. Some of these factors are described in Item 1A - Risk Factors in the Company s annual report on Form 10-K for the year ended December 31, 2013, as filed on March 17, 2014 with the SEC. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that the Company files with the SEC, could cause its actual results to differ materially from those included in any forward-looking statements the Company makes. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect the Company. Except as required by law, the Company is not obligated to, and does not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with the Company s financial statements and the accompanying notes to the Company s financial statements, which are included in Item 1 of this Quarterly Report on Form 10-Q, as well as the information contained in the Company s annual report on Form 10-K for the year ended December 31, 2013, as filed on March 17, 2014 with the SEC.

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Overview

Western Asset Mortgage Capital Corporation (the Company unless otherwise indicated or except where the context otherwise requires we , us or our) is primarily focused on investing in, financing and managing Agency RMBS. Although our core investment strategy is focused on Agency RMBS, we have opportunistically supplemented our portfolio with Non-Agency RMBS, Agency and Non-Agency CMBS and depending on current market conditions, may increase or decrease our investment in Non-Agency RMBS and Agency and Non-Agency CMBS in the future. We finance investments in RMBS and CMBS primarily through the use of repurchase agreements.

We were organized as a Delaware corporation on June 3, 2009, but did not commence operations until the completion of our IPO on May 15, 2012. We operate and elected to be taxed as a real estate investment trust (REIT), commencing with our taxable year ended December 31, 2012. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute, in accordance with the REIT regulations, all of our net taxable income to stockholders and maintain our intended qualification as a REIT. We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940 (1940 Act).

We are externally managed and advised by Western Asset Management Company (WAM , or the Manager), an SEC-registered investment advisor and a wholly-owned subsidiary of Legg Mason, Inc. Our Manager is responsible for administering our business activities and our day-to-day operations, subject to the supervision of our board of directors.

On May 9, 2012, we entered into: (i) a binding underwriting agreement with a group of underwriters to sell 8.0 million shares of our common stock for $20.00 per share in our initial public offering (IPO) for an aggregate offering price of $160.0 million; (ii) unit purchase agreements, pursuant to a private placement, with certain institutional accredited investors to purchase 2,231,787 warrant units for $20.00 per unit for an aggregate offering price of approximately $44.6 million; and (iii) a security purchase agreement to sell 46,043 shares of our common stock for $20.00 per share to our Manager s deferred compensation plan in another private placement for an aggregate offering price of approximately $0.9 million.

Each of the aforementioned warrant units consists of one share of our common stock and a warrant to purchase 0.5 of a share of our common stock. Each warrant had an initial exercise price of $20.50 per share, subject to adjustment upon the occurrence of customary events triggering an anti-dilution adjustment and certain sales of our common stock (see discussion below). In addition, the warrants are subject to certain limitations on exercise.

The net proceeds from our IPO and concurrent private placements were received on May 15, 2012. The net proceeds to us were approximately $204.4 million, net of offering expenses of $1.2 million for which we agreed to be responsible. Our Manager agreed to be responsible for all offering expenses in excess of $1.2 million, including the underwriting discount and the placement agent fees in the two private placements (in the aggregate, approximately $7.8 million).

On October 3, 2012, we completed a follow-on public offering of 13.8 million shares of common stock, at a price of $22.20 per share. We received net proceeds of approximately $301.0 million, net of underwriting commissions and offering expenses of approximately $5.4 million.

On October 3, 2012, as a result of the follow-on public offering of common stock the exercise price of each of the outstanding warrants was reduced from $20.50 to $19.44. In addition, on December 19, 2013, we declared a dividend payable in a combination of stock and cash. As a result of the stock portion of the aforementioned dividend paid on January 28, 2014, the exercise price of each of the outstanding warrants was further reduced to $17.59 and the number of warrant shares purchasable increased to 1,232,916.

We have invested the proceeds of our IPO, concurrent private placements and follow-on public offering primarily in Agency RMBS, including Mortgage pass-through certificates, Agency derivatives, Agency Interest-Only Strips, and Agency CMOs, Non-Agency RMBS as well as Agency and Non-Agency CMBS. We have also used to-be-announced forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase, for future delivery, Agency RMBS with certain principal and interest terms. At March 31, 2014, our portfolio was comprised of approximately $2.8 billion of Agency RMBS, approximately $422.3 million of Non-Agency RMBS, approximately $19.8 million Agency CMBS and approximately $25.3 million Non-Agency CMBS, exclusive of linked transactions. In addition, at March 31, 2014, our linked transactions included approximately $15.7 million of Non-Agency MBS.

We use leverage, currently comprised of borrowings under repurchase agreements, as part of our business strategy in order to increase potential returns to stockholders. We accomplish this by borrowing against existing mortgage-backed securities through repurchase agreements. There are no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio. We may also change our financing strategy and leverage without the consent of stockholders.

As of March 31, 2014, we had entered into master repurchase agreements with 20 counterparties. As of March 31, 2014, we had approximately $2.8 billion of borrowings, including borrowing on linked transactions, outstanding under our repurchase agreements collateralized by approximately $3.1 billion of MBS. The balance outstanding at March 31, 2014 includes approximately $12.7 million related to linked transactions collateralized by approximately $15.7 million of MBS. We have entered into swaps to effectively fix the interest rate of our borrowings (for the life of the swap); net of variable-rate payment swaps, the floating interest rate of approximately $2.9 billion of borrowings under our repurchase agreements, excluding forward starting swaps of $653.8 million. In addition, as of March 31, 2014, we also owned swaptions on approximately an incremental $2.1 billion of borrowings. As of March 31, 2014, our aggregate debt-to-equity ratio was approximately 7.4 to 1, including repurchase agreements on linked transactions and 7.3 to 1, excluding repurchase agreements on linked transactions.

Recent Market Conditions and Strategy

Our business is affected by general U.S. residential real estate fundamentals and the overall U.S. economic environment. In particular, our strategy is influenced by the specific characteristics of these markets, including prepayment rates and interest rate levels. We expect the results of our operations to be affected by various factors, many of which are beyond our control. Our results of operations will primarily depend on, among other things, the level of our net interest income, the market value of our investment portfolio and the supply of and demand for mortgage-related securities. Our net interest income, which includes the amortization of purchase premiums and accretion of discounts, will vary primarily as a result of changes in interest rates, borrowing costs, and prepayment speeds on our MBS investments. Similarly, the overall value of our MBS investment portfolio will be impacted these factors as well as changes in the value of residential and commercial real estate and continuing regulatory changes.

The current economic and market outlook are shaped in a significant manner by the unprecedented level of fiscal and monetary stimulus that the U.S. Government and U.S. Federal Reserve Board provided in the aftermath of the 2007-2010 financial crisis. The current rate environment is characterized by a steep yield curve with the spread between two-year U.S. Treasury Notes and ten-year U.S. Treasury Notes well above the average spread over the last three decades. The U.S. Federal Reserve Board has maintained a near-zero target for the federal funds rate, and has reiterated its commitment to fulfilling its mandate to promote higher growth and lower unemployment and to maintain price stability in the U.S. economy. On April 30, 2014, the U.S. Federal Reserve Board reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate.

It is our Manager s view that while recent economic data suggests an improvement in U.S. economic growth, the significant mortgage debt burden, run-off of fiscal stimulus and budget discipline at both the U.S. federal and state level will serve as an impediment to real GDP and employment growth throughout 2014 and early 2015. Recent headline inflation data remains relatively modest and we do not believe core rates will increase meaningfully, largely due to a plentiful supply of labor, thereby effectively eliminating wage pressure, and low rates of resource utilization. For these reasons, and considering its dual mandate to manage both inflation and unemployment, we believe that the U.S. Federal Reserve Board will continue to exercise patience in unwinding any form of monetary stimulus now in effect. U.S. Federal Reserve Chair Yellen affirmed this position during her Humphrey Hawkins testimony in February 2014, stating that purchases of Agency RMBS and U.S. Treasuries were not on a pre-set course and that she expected that highly accommodative monetary policy would remain appropriate for a considerable time after the asset purchases end. Despite the recent decline in the unemployment rate to 6.3%, Ms Yellen in her May 2014 testimony to the congressional Joint Economic Committee expressed continuing concern regarding the overall health of the labor market. She pointed out that

the jobless rate continues to be elevated and stated, Moreover, both the share of the labor force that has been unemployed for more than six months and the number of individuals who work part time but would prefer a full-time job are at historically high levels. While the yield curve did flatten during the first quarter of 2014, we expect that, on a historical basis, the yield curve will remain relatively steep due to the continuing muted recovery. Barring any system shocks to the capital markets, this should provide for continued strong demand for mortgage securities.

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As the capital markets have recovered, commercial banks have re-entered the secured lending market, which has quickened the pace of asset recovery, and the return to more normalized credit spreads. Financing of Agency and Non-Agency RMBS as well as Agency and Non-Agency CMBS is currently widely available through, among other vehicles, repurchase agreements. Haircuts, or the discount attributed to the value of securities sold under repurchase agreements, range from a low of 3.0% to a high of 5.5% for Agency RMBS, depending on the specific security used as collateral for such repurchase agreements, while haircuts for IOs and IIOs can be as high as 30.0% and haircuts for Non-Agency RMBS and Agency and Non-Agency CMBS range from a low of 10.0% to a high of 45.0%. Even during last year s market volatility, such financing remained readily available. Notwithstanding the foregoing, such financing may not be as readily available in the future as a result of the increased regulatory capital requirements under the Dodd-Frank Act and Basel III.

Toward the end of the 2012, we acquired a small position of Non-Agency RMBS. During 2013 we increased our position in Non-Agency RMBS and made our first investment in CMBS. During the first quarter of 2014, we continued to reposition our portfolio to opportunistically take advantage of changes in market conditions. Currently, our Manager plans to increase our investment in Non-Agency RMBS and Agency and Non-Agency CMBS. Our Manager believes that Non-Agency RMBS and CMBS can serve as a diversifying investment for the portfolio in the event interest rates rise.

In response to the financial crisis, the U.S. government, through the FHA, the Federal Deposit Insurance Corporation, or FDIC, and the U.S. Treasury, has commenced or proposed implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. These loan modification and refinance programs, future U.S. federal, state and/or local legislative or regulatory actions that result in the modification of outstanding mortgage loans, as well as changes in the requirements necessary to qualify for refinancing mortgage loans with FNMA, FHLMC or GNMA, may adversely affect the value of, and the returns on, residential mortgage loans, RMBS, real estate-related securities and various other asset classes in which we may invest. In addition to the foregoing, the U.S. Congress and/or various states and local legislators may enact additional legislation or regulatory action, such as the recently enacted qualifying mortgage requirements under the Dodd-Frank Act, to address the current economic crisis or for other purposes that could have a material adverse effect on our ability to execute our business strategies.

On January 4, 2012, the U.S. Federal Reserve Board released a report titled *The U.S. Housing Market: Current Conditions and Policy Considerations* to Congress providing a framework for thinking about certain issues and tradeoffs that policy makers might consider. In March 2014, Senate Banking Committee Chairman Tim Johnson and Ranking Member Mike Crapo announced an agreement on their own version of GSE reform which would eventually replace FNMA and FHLMC with a new system. It is unclear how future legislation may impact the housing finance market and the investing environment for agency securities as the method of reform is undecided and has not yet been defined by the regulators.

In September 2012, the U.S. Federal Reserve implemented a third round of quantitative easing or QE3 to expand its holdings of long-term securities by purchasing an additional $40 billion of Agency RMBS per month until key economic indicators, such as the unemployment rate, showed signs of improvement. This program when combined with existing programs to extend the average maturity of the Federal Reserve s holdings of securities and reinvest principal payments from the Federal Reserve s holdings of Agency debt and Agency RMBS into Agency RMBS resulted in an increase to the Federal Reserve s purchases of long-term securities to $85 billion a month. The Federal Reserve implemented QE3 in expectation that such measures would put downward pressure on long-term interest rates. In May 2013, former Federal Reserve Chairman Bernanke announced that due to improvements in the overall economy, the Federal Reserve was contemplating reducing its monthly purchases. In December 2013, the Federal Reserve announced that beginning in January 2014, the Federal Reserve would begin the tapering of QE3 by reducing its monthly purchases of Agency MBS from $40 billion to $35 billion and its monthly purchases of longer term U.S. Treasury securities from $45 billion to $40 billion while still maintaining its existing policy of reinvesting principal payments from its holdings of Agency debt and Agency MBS in Agency MBS. In April 2014, the Federal Reserve announced that it would continue to reduce its monthly purchases of Agency MBS and U.S. Treasuries securities while still maintaining its reinvestment policy. As of May 2014, monthly purchases of Agency MBS would be reduced from $25 billion to $20 billion and monthly purchases of U.S. Treasury securities would be reduced from $30 billion to $25 billion. Notwithstanding the foregoing, the Federal Reserve reaffirmed that its view that a highly accommodative monetary policy would remain appropriate for a considerable time after the purchase program ends and the economic recovery

strengthens.

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Our Investment Strategy

Our Manager s investment philosophy, which developed from a singular focus in fixed-income asset management over a variety of credit cycles and conditions, is to provide clients with diversified, tightly controlled, long-term value-oriented portfolios. Through rigorous analysis of all sectors of the fixed-income market, our Manager seeks to identify assets with the greatest risk-adjusted total value potential. In making investment decisions on our behalf, our Manager incorporates its views on the economic environment and the outlook for the mortgage markets, including relative valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, commercial and residential real estate prices, delinquencies, default rates, recovery of various segments of the economy and vintage of collateral, subject to maintaining our REIT qualification and our exemption from registration under the 1940 Act. We benefit from the breadth and depth of our Manager s overall investment philosophy, which focuses on a macroeconomic analysis as well as an in-depth analysis of individual assets and their relative value.

We rely on our Manager s expertise in asset allocation and identifying attractive assets within our investment strategy. Although our core investment strategy is currently focused primarily on Agency RMBS, our Manager s expertise in related investment disciplines such as Non-Agency RMBS, CMBS , and ABS provides our Manager with both: (i) valuable investment insights to our Agency RMBS investment selection and strategy; and (ii) flexibility to invest in assets other than Agency RMBS opportunistically as market conditions warrant.

We currently purchase and sell Agency RMBS as our primary investment but also invest in Non-Agency RMBS, Agency and Non-Agency CMBS, as well as to-be-announced forward contracts, or TBAs. Currently, our Manager expects to expand our purchase of Non-Agency RMBS and Agency and Non-Agency CMBS. Our Manager has not and does not expect to purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular security or our capital position.

Our Target Assets

We have invested the proceeds of our IPO, concurrent private placements and follow-on public offering and expect to continue to focus on investing in the following types of securities:

Agency RMBS - Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as Government National Mortgage Association (GNMA), or a U.S. Government-sponsored entity, such as Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC). The Agency RMBS we acquire can be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on the amount by which the loan interest rate can change on any predetermined interest rate reset date. As of March 31, 2014, all of our Agency RMBS are secured by fixed-rate mortgages.

Mortgage pass-through certificates. - Mortgage pass-through certificates are securities representing interests in pools of mortgage loans secured by residential real property where payments of both interest and scheduled principal, plus pre-paid principal, on the securities are made monthly to holders of the securities, in effect passing through monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor of the securities and servicers of the underlying mortgages.

Interest-Only Strips or IOs. - This type of security only entitles the holder to interest payments. The yield to maturity of Interest-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of particularly attractive prepayment-related or structural opportunities in the MBS markets, as well as to help manage the duration of our overall portfolio.

Inverse Interest-Only Strips or IIOs. - This type of security has a coupon with an inverse relationship to its index and is subject to caps and floors. Inverse Interest-Only MBS entitles the holder to interest only payments based on a notional principal balance, which is typically equal to a fixed rate of interest on the notional principal balance less a floating rate of interest on the notional principal balance that adjusts according to an index subject to set minimum and maximum rates. The current yield of Inverse Interest-Only MBS will generally decrease when its related index rate increases and increase when its related index rate decreases.

Principal-Only Strips. This type of security generally only entitles the holder to receive cash flows that are derived from principal repayments of an underlying loan pool, but in the case of Non-Agency Principal-Only Strips will also include cash flows from default recoveries and excess interest. The yield to maturity of Principal-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of structural opportunities in the MBS markets.

TBAs. - We may utilize TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we would agree to purchase (or deliver), for future settlement, Agency RMBS with certain principal and interest terms and certain types of underlying collateral, but the particular Agency RMBS to be delivered would not be identified until shortly before the TBA settlement date. Our ability to purchase Agency RMBS through TBAs may be limited by the 75% income and asset tests applicable to REITs.

Collateralized Mortgage Obligations or CMOs. - CMOs are securities that are structured from residential and/or commercial pass-through certificates, which receive monthly payments of principal and interest. CMOs divide the cash flows which come from the underlying mortgage pass-through certificates into different classes of securities that may have different maturities and different weighted average lives than the underlying pass-through certificates.

Non-Agency RMBS. - RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations.

The mortgage loan collateral for Non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of agency underwriting guidelines, borrower characteristics, loan characteristics and level of documentation, and therefore are not issued or guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower s credit rating and the underlying level of documentation. Non-Agency RMBS may be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

Agency CMBS. - We may also invest in fixed and floating rate commercial mortgage-backed securities, or CMBS, for which the principal and interest payments are guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, but for which the underlying mortgage loans are secured by real property other than single family residences. These may include, but are not limited to Fannie Mae DUS (Delegated Underwriting and Servicing) MBS, Freddie Mac Multifamily Mortgage Participation Certificates and Ginnie Mae project loan pools, and/or CMOs structured from such collateral.

Non-Agency CMBS. - Fixed and floating rate CMBS for which the principal and interest payments are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity. To date, our primary emphasis has been on legacy securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. We have not established a minimum current rating requirement and in the future may invest in subordinated classes.

Agency and Non-Agency CMBS IO and IIO Securities. Interest-Only and Inverse Interest-Only securities for which the underlying collateral is commercial mortgages the principal and interest on which may or may not be guaranteed by a U.S Government agency or U.S. Government-sponsored entity. Unlike single family residential mortgages in which the borrower, generally, can prepay at any time, commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as defeasance.

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Our primary investment strategy continues to focus on Agency RMBS. As discussed above, we continued to increase the portion of our portfolio allocated to Non-Agency RMBS and Agency and Non-Agency CMBS and are likely to expand our investments in these securities in the future. In addition, we may also invest in asset-backed securities or ABS which we describe below. The allocation to Non-Agency RMBS, Agency and Non-Agency CMBS, and ABS may vary from time to time based on market conditions and differ from target ranges identified for these asset classes at the time of our initial public offering.

ABS. - Debt and/or equity tranches of securitizations backed by various asset classes including, but not limited to, small balance commercial mortgages, aircrafts, automobiles, credit cards, equipment, manufactured housing, franchises, recreational vehicles and student loans with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. Investments in ABS generally are not qualifying assets for purposes of the 75% asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

Residential and commercial whole-loans. - We may in the future invest in or seek to gain exposure to whole loan mortgages, secured by both single family residential and/or commercial properties. In this regard, our Manager is currently exploring the benefits and costs, including legal and regulatory impact, of such investments. As currently contemplated, this program would involve investing in mortgage loans directly or in structured Non-Agency RMBS programs crafted specifically for us. In addition to holding these instruments for investment, we might invest in or acquire whole-loans directly or gain exposure to whole-loans through investments in structured programs with the intention of securitizing the whole-loans in the future, selling the investment grade portion of the securitized structure and retaining the residual portion. Adding these instruments to our target assets involves complex investment, structural, regulatory and accounting issues and there can be no assurance that we will in fact expand its target assets to include whole loans or, if it does, in what form and to what extent it will do so.

As of March 31, 2014, the fair value of our investment portfolio was comprised of 85.6 % of Agency RMBS, 13.0% of Non-Agency RMBS, 0.6% of Agency CMBS and 0.8% of Non-Agency CMBS, excluding linked transactions. As of March 31, 2014, the fair value of our investment portfolio was comprised of 85.2% of Agency RMBS, 13.4% of Non-Agency RMBS, 0.6% of Agency CMBS and 0.8% of Non-Agency CMBS, including linked transactions.

Our Financing Strategy

The leverage that we employ is specific to each asset class and is determined based on several factors, including potential asset price volatility, margin requirements, the current cycle for interest rates, the shape of the yield curve, the outlook for interest rates and our ability to use and the effectiveness of interest rate hedges. We analyze both historical volatility and market-driven implied volatility for each asset class in order to determine potential asset price volatility. Our leverage targets attempt to risk-adjust asset classes based on each asset class s potential price volatility. The goal of our leverage strategy is to ensure that, at all times, our investment portfolio s overall leverage ratio is appropriate for the level of risk inherent in the investment portfolio.

We may fund the acquisition of our assets through the use of leverage from a number of financing sources, subject to maintaining our qualification as a REIT. We finance purchases of MBS primarily through the use of repurchase agreements.

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. We use leverage to increase potential returns to our stockholders. We currently accomplish this by borrowing against existing assets through repurchase agreements. Our investment policies place no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio. We may also change our financing strategy and leverage without the consent of our stockholders.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If either of these events happens, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

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We expect to maintain a debt to equity ratio of six to ten times the amount of our stockholders equity, although there is no minimum or maximum leverage that our investment policies explicitly require. To the extent the Agency percentage of our portfolio decreases, our overall leverage is likely to decrease. Depending on the different cost of borrowing funds at different maturities, we will vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. We enter into collateralized borrowings only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. We rely on financing to acquire, on a leveraged basis, assets in which we invest. If market conditions deteriorate, our lenders may exit the repurchase market, and tighten lending standards, or increase the amount of equity capital required to obtain financing making it more difficult and costly for us to obtain financing.

For the three months ended March 31, 2014, we financed our MBS with repurchase agreements, on a debt-to-equity basis, ranging from approximately six to eight times leverage throughout the period. In the future, we may, however, be limited or restricted in the amount of leverage we may employ by the terms and provisions of any financing or other agreements, and may be subject to margin calls as a result of our financing activity. We had an aggregate debt-to-equity ratio, related to our repurchase agreements of approximately 7.4 to 1, including repurchase agreements on linked transactions, and 7.3 to 1, excluding repurchase agreements on linked transactions at March 31, 2014. Our debt-to-equity ratio is computed by dividing repurchase borrowings by total stockholders equity.

We finance MBS with repurchase agreement financing with maturities ranging from one to three months, but in some cases longer. At March 31, 2014, we had entered into master repurchase agreements with 20 counterparties. We had approximately $2.8 billion outstanding under our repurchase agreements, including repurchase agreements accounted for as part of linked transactions at March 31, 2014. The balance outstanding at March 31, 2014 includes approximately $12.7 million related to linked transactions.

Our Hedging Strategy

Subject to maintaining our qualification as a REIT for U.S. federal income purposes, we pursue various economic hedging strategies to seek to reduce our exposure to adverse changes in interest rates. The U.S. federal income tax rules applicable to REITs may require us to implement certain of these techniques through a domestic taxable REIT subsidiary (TRS) that is fully subject to federal corporate income taxation. At this time we do not utilize a domestic TRS, although we may consider doing so in future. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. As of March 31, 2014, we entered into swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps generally provide for fixed interest rates indexed off of the London interbank offered rate or LIBOR and effectively fix the floating interest rates. Notwithstanding the foregoing, in order to manage our hedge position with regard to our liabilities, we on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for us making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. As of March 31, 2014, we effectively fixed the floating interest rates on approximately $2.9 billion of borrowings under our repurchase agreements, net of variable-rate payment swaps. We also entered into forward starting swaps of $653.8 million. We utilize forward starting swaps and swaptions for several reasons including replacing expiring swaps, in anticipation of increasing our overall financing and reducing our exposure to future interest rate increases. Interest rate swaptions provide us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. As of March 31, 2014, we owned swaptions on approximately an incremental $2.1 billion of borrowings. To date, we have not elected to apply hedge accounting for our derivatives and, as a result, we record the change in fair value of our derivatives and the associated interest in earnings.

Our hedging techniques are partly based on assumed levels of prepayments of our target assets. If prepayments are slower or faster than assumed, the life of the investment will be longer or shorter, which would reduce the effectiveness of any hedging strategies we may use and may cause losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns.

Critical Accounting Policies

Our financial statements are prepared in accordance with GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. In accordance with SEC guidance, the following discussion addresses the accounting policies that we currently apply. Our most critical accounting policies will involve decisions and assessments that could 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 have been based were reasonable at the time made and based upon information available to us at that time. We have identified what we believe will be our most critical accounting policies to be the following:

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Investments

We elected the fair value option for all of our MBS and other securities at the date of purchase, which permits us to measure these securities at fair value with the change in fair value included as a component of earnings. Although we have elected the fair value option for our MBS, we separately compute interest income on our MBS under the prescribed method based on the nature of the security. As such, premiums and discounts are amortized or accreted into interest income and are included in Interest income in the Statement of Operations.

Valuation of financial instruments

We disclose the fair value of our financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, we are required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring fair value in accordance with GAAP and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

When available, we use quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, we consult with independent pricing services or obtain third party broker quotes. If independent pricing service, or third party broker quotes are not available, we determine the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates.

While linked transactions are treated as derivatives for GAAP, the securities underlying the Company s linked transactions are valued using similar techniques to those used for our securities portfolio. The value of the underlying security is then netted against the carrying amount

(which approximates fair value) of the repurchase agreement at the valuation date. Additionally, TBA instruments are similar in substance to our Agency RMBS portfolio, and the Company therefore estimates fair value based on similar methods.

We determine the fair value of derivative financial instruments by obtaining quotes from a third party pricing service, whose pricing is subject to review by our Manager s pricing committee. In valuing our interest rate derivatives, such as swaps and swaptions, we consider the creditworthiness of our counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both us and our counterparties. All of our interest rate swaps are either cleared through a central clearing house and subject to the clearing house margin requirements or subject to bilateral collateral arrangements with the vast majority of interest rate swaps entered into beginning in September 2013 being cleared through a central clearing house. We also have netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association. Consequently, no credit valuation adjustment was made in determining the fair value of interest rate derivatives.

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Valuation techniques for MBS may be based upon models that consider the estimated cash flows of the security. The primary inputs to the model include yields for to-be-announced (also known as TBAs) Agency RMBS, the U.S. Treasury market and floating rate indices such as LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. To the extent, the inputs are observable and timely, the MBS are categorized in Level II of the fair value hierarchy; otherwise, unless alternative pricing information as described is available, they are categorized as Level III.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If we are forced to sell assets in a short period to meet liquidity needs, the prices we receive could be substantially less than the recorded fair values of our assets. Furthermore, the analysis of whether it is more likely than not that we will be required to sell securities in an unrealized loss position prior to an expected recovery in value (if any), the amount of such expected required sales, and the projected identification of which securities will be sold is also subject to significant judgment, particularly in times of market illiquidity.

We determine the fair value of derivative financial instruments and obtain quotations from a third party to facilitate the process of determining these fair values.

We will review any changes to the valuation methodology to ensure the changes are appropriate. The methods used may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while we anticipate that our valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments can result in a different estimate of fair value at the reporting date. We use inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

All valuations received from independent pricing services are non-binding. We primarily utilize an independent third party pricing service as the primary source for valuing the Company s assets.

We generally receive one independent pricing service price for each investment in our portfolio. Our Manager has established a process to review and validate the pricing received from the independent pricing service and has a process for challenging prices received from the independent pricing service when necessary. The Company utilizes our Manager s policies in this regard. Our and our Manager s review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. Our Manager s pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager s pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that our Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, our Manager generally challenges the independent pricing service price.

To ensure proper fair value hierarchy, we and our Manager review the methodology used by the third party pricing service to understand whether observable market data is being utilized in the vendor s pricing methodology. Generally, this review is conducted annually, however ad-hoc reviews of the pricing methodology and the data do occur. The review of the assumptive data received from the vendor includes comparing key inputs. In addition, as part of our regular review of pricing, our Manager s pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination. The conclusion that a price should be overridden in accordance with our Manager s pricing methodology may impact the fair value hierarchy of the security for which such

price has been adjusted.

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Linked transactions

In instances where we finance the acquisition of securities through repurchase agreements with the same counterparty from which the securities were purchased, we evaluate such transactions in accordance with GAAP. This guidance requires the initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another to be considered linked unless all of the criteria found in the guidance are met at the inception of the transaction. If the transaction meets all of the conditions, the initial transfer shall be accounted for separately from the repurchase financing, and we will record the securities and the related financing on a gross basis on our Balance Sheet with the corresponding interest income and interest expense in our Statements of Operations. If the transaction is determined to be linked, we will record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase securities as a derivative instrument with changes in market value being recorded on our Statement of Operations. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in Gain (loss) on linked transactions, net on our Statement of Operations. We refer to these transactions as Linked Transactions. When or if a transaction is no longer considered to be linked, the real estate security and related repurchase financing will be reported on a gross basis. The unlinking of a transaction causes a realized event in which the fair value of the real estate security as of the date of unlinking will become the cost basis of the real estate security. The difference between the fair value on the unlinking date and the existing cost basis of the security will be the realized gain or loss. Recognition of effective yield for such security will be calculated prospectively using the new cost basis. For linked transactions, we reflect purchases and sales of securities within the investing section of our Statement of Cash Flows. Proceeds from repurchase agreements borrowings and repayments of repurchase agreement borrowings are reflected in the financing section of our Statement of Cash Flows.

The securities underlying our linked transactions are valued using similar techniques to those used for our securities portfolio.

Interest income recognition and Impairment

Agency MBS and Non-Agency MBS excluding Interest-Only Strips, rated AA and higher at the time of purchase

Interest income on mortgage-backed securities is accrued based on the respective outstanding principal balances and their corresponding contractual terms. Premiums and discounts associated with Agency MBS and Non-Agency MBS, excluding Interest-Only Strips, rated AA and higher at the time of purchase are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. On at least a quarterly basis, we estimate prepayments for our securities and, as a result, if prepayments increase (or are expected to increase), we will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) we will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

A decline in the fair market value of our assets may require us to recognize an other-than-temporary impairment against such assets under GAAP unless we were to determine that, with respect to any assets in unrealized loss positions, we do not have the intent to sell these investments, it is more likely than not that we will not be required to sell the investment before recovery of a security s amortized cost basis and we will not be required to sell the security for regulatory or other reasons. In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current

yield used to accrete interest income. If such a determination is made, we would recognize unrealized losses through earnings and write down the amortized cost of such assets to a new cost basis, based on the fair value of such assets on the date they are considered to be other-than-temporarily impaired. Other than for plain-vanilla variable rate Non-Agency MBS we do not bifurcate the loss between credit loss and loss attributed to change in interest rates, therefore, the entire loss is recorded as other-than-temporary. Such impairment charges reflect non-cash losses at the time of recognition; subsequent disposition or sale of such assets can further affect our future losses or gains, as they are based on the difference between the sales price received and adjusted amortized cost of such assets at the time of sale.

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The determination of whether an other-than-temporary impairment exists is subject to management s estimates based on consideration of both factual information available at the time of assessment as well as our estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Non-Agency MBS that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives

Interest income on Non-Agency MBS that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives are recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on our observation of the then current market information and events and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our judgment about interest rates, prepayment rates, the timing and amount of credit losses (if applicable), and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the associated mortgage collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flows from any Non-Agency MBS, which we may purchase at a discount to par value, a portion of the purchase discount may be designated as credit protection against future credit losses and, therefore, not accreted into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. The Company does not bifurcate the loss between credit loss and loss attributed to change in interest rates, therefore, the entire loss is recorded as other-than-temporary. These adjustments are reflected in our Statement of Operations as Other loss on Mortgage-backed securities.

Following the recognition of an other-than-temporary impairment, a new amortized cost basis is established for the security. However, to the extent that there are subsequent increases in cash flows expected to be collected, the other-than-temporary impairment previously recorded may be accreted back through interest income via increased yield.

The determination of whether an other-than-temporary impairment exists is subject to management s estimates based on consideration of both factual information available at the time of assessment as well as our estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Derivatives and hedging activities

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. Derivatives are used for hedging purposes rather than speculation. We determine their fair value and obtain quotations from a third party to facilitate the process of determining these fair values. If our hedging activities do not achieve the desired results, reported earnings may be adversely affected.

GAAP requires an entity to recognize all derivatives as either assets or liabilities on the Balance Sheet and to measure those instruments at fair value. Fair value adjustments are recorded in earnings immediately, if the reporting entity does not elect hedge accounting for a derivative instrument.

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We elected not to apply hedge accounting for these derivative instruments and record the change in fair value and net interest rate swap payments (including accrued amounts) related to interest rate swaps in Gain (loss) on derivative instruments, net in our Statement of Operations.

We also invest in Agency and Non-Agency Interest-Only Strips, swaptions, futures contracts and TBAs. We evaluate the terms and conditions of our holdings of Agency and Non-Agency Interest-Only Strips, swaptions, futures contracts and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of our holdings of Interest-Only Strips, we evaluate the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on our Balance Sheet utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value. Accordingly, Agency and Non-Agency Interest-Only Strips, swaptions, futures contracts and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in our Statement of Operations, along with any interest earned (including accrued amounts). The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in Mortgage-backed securities on the Balance Sheet. The carrying value of swaptions, futures contracts and TBAs is included in Derivative assets or Derivative liabilities on the Balance Sheet.

We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contact and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option are not bifurcated. Our derivative instruments also include linked transactions, which reflect a forward commitment to purchase assets. Derivative instruments are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned (including accrued amounts) reported in Gain (loss) on derivative instruments, net in our Statement of Operations.

Repurchase agreements

Mortgage-backed securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on our Balance Sheet as an asset and the amount of cash received from the lender is recorded in our Balance Sheet as a liability. Interest paid in accordance with repurchase agreements is recorded as interest expense.

In instances where we acquire securities through repurchase agreements with the same counterparty from which the securities were purchased, we will account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase securities as a derivative instrument if the transaction does not comply with the criteria for gross presentation. Such forward commitments will be recorded at fair value with subsequent changes in fair value recognized in income. Additionally, we will record the cash portion of our investment in securities as a mortgage-related receivable from the counterparty on our balance sheet. If the transaction complies with the criteria for gross presentation, we will record the assets and the related financing on a gross basis in our Balance Sheet and the corresponding interest income and interest expense in our Statements of Operations.

Share-based compensation

We account for share-based compensation to our independent directors, to our officers and employees, to our Manager and to employees of our Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to our independent directors and employees is measured at its fair value at the grant date, and amortized into expense over the service period on a straight-line basis. Compensation cost related to restricted common stock issued to our Manager and to employees of our Manager and its affiliates is initially measured at fair value at the grant date, and re-measured at fair value on subsequent dates to the extent the awards are unvested and the change in fair value is reported in the Statement of Operations as non-cash stock based compensation.

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Warrants

We account for the warrants comprising a part of the units issued in the private placement to certain institutional accredited investors concurrent with our IPO in accordance with Accounting Standards Codification 815, Accounting for Derivative Instruments and Hedging Activities, which provides guidance on the specific accounting treatment of a multitude of derivative instruments. We have evaluated the warrants issued by us and have recorded the warrants at their relative fair value as a component of equity, using a variation of the adjusted Black-Scholes option valuation model at their time of issuance.

Income taxes

We operate and have elected to be taxed as a REIT commencing with our taxable year ended December 31, 2012. Accordingly, we will generally not be subject to corporate U.S. federal or state income tax to the extent that we make qualifying distributions to our stockholders, and provided that we satisfy on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which we lost our REIT qualification. Accordingly, our failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to our stockholders.

Our dividends paid deduction for qualifying dividends paid to our stockholders is computed using our taxable income as opposed to net income reported on the financial statements. Taxable income, generally, will differ from net income reported on the financial statements because the determination of taxable income is based on tax provisions and not financial accounting principles.

We may elect to treat certain of our subsidiaries as TRSs. In general, a TRS of ours may hold assets and engage in activities that we cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes. While a TRS will generate net income, a TRS can declare dividends to us, which will be included in our taxable income and necessitate a distribution to our stockholders. Conversely, if we retain earnings at the TRS level, no distribution is required and we can increase book equity of the consolidated entity. As of March 31, 2014, we did not have a TRS, or any other subsidiary.

We evaluate uncertain tax positions, if any, and classify interest and penalties, if any, related to unrecognized tax benefits as a component of the provision for income taxes.

Accounting standards applicable to emerging growth companies

The JOBS Act contains provisions that relax certain requirements for emerging growth companies for which we qualify. For as long as we are an emerging growth company, which may be up to five full fiscal years, unlike other public companies, we will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor s attestation report on management s assessment of the effectiveness of our

system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise. We may take advantage of any or all of such exemptions, but have not yet made a decision on whether to do so.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. We currently intend to take advantage of such extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

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Recent accounting pronouncements

Accounting Standards to be Adopted in Future Periods

In April 2014, the Financial Accounting Standards Board issued updated guidance that changes the requirements for reporting discontinued operations. Under the new guidance, a discontinued operation is defined as a disposal of a component of an entity or group of components of an entity that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity s operations and financial results. The guidance is effective prospectively as of the first quarter of 2015, with early adoption permitted for new disposals or new classifications as held-for-sale. The guidance is effective for annual periods beginning on or after December 15, 2014 and interim periods within annual periods beginning on or after December 15, 2015. Early adoption is permitted but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue. The new guidance is not expected to have a material impact on our financial statements.

Results of Operations

The following discussion of our results of operations highlights our performance for the three months ended March 31, 2014 and 2013. For the three months ended March 31, 2014, we had a net loss of $8.4 million or $0.32 per basic and diluted weighted average common share. For the three months ended March 31, 2013, we had net loss of $28.5 million or $1.18 per basic and diluted weighted average common share. During 2013, and continuing through the first quarter of 2014, we expanded our investment in Non-Agency MBS and commenced investing in CMBS and adjusted our overall leverage and hedging strategy pursuant to our current business plan.

Investments

The following table presents certain information about our MBS investment portfolio at March 31, 2014 which is a Non-GAAP measure due to the inclusion of our Linked Transactions, in order to present a complete economic presentation of our MBS portfolio, which is reconciled to GAAP below, as follows (dollars in thousands)**:**

	Principal Balance	Unamortized Premium (Discount)	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss)	Estimated Fair Value	Net Weighted Average Coupon (1)
20-Year Mortgage							
Coupon Rate:							
3.00%	$ 360,647	$ 17,376	$	$ 378,023	$ (16,639)	$ 361,384	3.0%
3.50%	97,865	6,196		104,061	(3,339)	100,722	3.5%
4.00%	334,985	21,652		356,637	(3,783)	352,854	4.0%
	793,497	45,224		838,721	(23,761)	814,960	3.5%
30-Year Mortgage							
Coupon Rate:							
3.50%	1,011,992	72,300		1,084,292	(69,838)	1,014,454	3.5%

4.00%	549,224	55,848		605,072	(33,949)	571,123	4.0%
4.50%	23,163	1,648		24,811	55	24,866	4.5%
5.50%	79,610	10,130		89,740	(43)	89,697	5.5%
6.00%	8,700	1,032		9,732	23	9,755	6.0%
	1,672,689	140,958		1,813,647	(103,752)	1,709,895	3.8%
Agency RMBS IOs and IIOs(2)	N/A	N/A		166,427	1,737	168,164	4.5%
Agency and Non-Agency IOs and IIOs accounted for as derivatives (2)(3)	N/A	N/A	N/A	N/A	N/A	110,330	3.3%
	N/A	N/A		166,427	1,737	278,494	3.9%
Non-Agency RMBS	488,080	16,440	(99,776)	404,744	10,082	414,826	5.9%
Non-Agency RMBS IOs and IIOs	N/A	N/A	N/A	19,322	676	19,998	5.6%
	488,080	16,440	(99,776)	424,066	10,758	434,824	5.8%
Agency and Non-Agency CMBS	27,239	(3,097)	(732)	23,410	1,898	25,308	3.8%
Total: Non GAAP Basis-Including Linked Transaction	2,981,505	199,525	(100,508)	3,266,271	(113,120)	3,263,481	4.0%
Linked Transactions	9,840	9,046	(3,559)	15,327	360	15,687	31.1%
Total: GAAP Basis	$ 2,971,665	$ 190,479	$ (96,949)	$ 3,250,944	$ (113,480)	$ 3,247,794	4.0%

(1) Net weighted average coupon as of March 31, 2014 is presented net of servicing and other fees.

(2) Agency RMBS IOs and IIOs, Non-Agency RMBS IOs, Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and Agency and Non-Agency CMBS IOs and IIOs have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At March 31, 2014, the notional balance for Agency RMBS IOs and IIOs, Non-Agency IOs, for Agency and Non-Agency IOs and IIOs, accounted for as derivatives, and Agency and Non-Agency CMBS IOs was $954,872, $909,502, $119,901 and $0, respectively.

(3) Interest on these securities is reported as a component of Gain (loss) on derivative instruments, net.

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As of March 31, 2014 and 2013, our portfolio consisted primarily of fixed-rate Agency RMBS which our Manager believes exhibit prepayment mitigation attributes, including Agency RMBS collateralized by low loan balances, loans where the underlying borrower is unable to access the Making Home Affordable Program, including the Home Affordable Refinance Program or HARP or loans which were not originated by third party originators or brokers.

The following table details the constant prepayment rates for our Agency portfolio as of March 31, 2014, based on our Manager s estimates which are based on third party models, as adjusted by our Manager, and are updated quarterly on a prospective basis:

Constant Prepayment Rates	Low	High
Agency RMBS		
20-Year Mortgage	3.55%	12.81%
30-Year Mortgage	4.40%	91.27%
Agency RMBS IOs and IIOs	4.57%	30.46%
Agency RMBS IOs and IIOs accounted for as derivatives	4.33%	30.91%
Agency CMBS IOs accounted for as derivatives(1)	N/A	N/A

(1) CMBS generally include prepayment restrictions; therefore, there are no Constant Prepayment Rates available.

The following table details information for our Non-Agency portfolio as of March 31, 2014, based on our Manager s estimates which are based on third party models, as adjusted by our Manager, and is updated quarterly on a prospective basis:

	Cumulative Default		Cumulative Severity		Cumulative 5-Year CRR	
	Low	High	Low	High	Low	High
Non-Agency RMBS	1.01%	60.70%	0.00%	118.23%	2.16%	11.15%
Non-Agency IOs and IIOs	29.96%	43.73%	21.99%	53.56%	5.34%	7.11%
Non-Agency CMBS	8.95%	31.29%	29.64%	60.67%	0.00%	11.52%
Linked transactions, net, at fair value	29.96%	33.93%	51.61%	53.56%	7.11%	7.34%

Investment Activity

Agency and Non-Agency RMBS, Agency and Non-Agency CMBS, IO and IIO Securities and Other Securities.

The following tables present our MBS portfolio activity, including linked transactions (Non-GAAP) for the three months ended March 31, 2014 and 2013 (dollars in thousands):

For the three months ended March 31, 2014

	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	$ 356,948	$ 47,183	$ 13,287
Non-Agency RMBS	104,057	7,653	103,176
Agency CMBS and Agency CMBS IOs and IIOs		420	
Non-Agency CMBS	14,699		
Total MBS: Excluding Linked Transactions (GAAP)	$ 475,704	$ 55,256	$ 116,463
Non-Agency RMBS Linked Transactions		3,018	
Total MBS: Including Linked Transactions (Non-GAAP)	$ 475,704	$ 58,274	$ 116,463

	For the three months ended March 31, 2013		
	Purchases	Principal Payments and Basis Recovery	Proceeds from Sales
Agency RMBS and Agency RMBS IOs and IIOs	$ 1,023,146	$ 77,721	$ 1,828,722
Non-Agency RMBS	127,565	1,772	
Total MBS: Excluding Linked Transactions (GAAP)	$ 1,150,711	$ 79,493	$ 1,828,722
Non-Agency RMBS Linked Transactions	66,704	569	
Total MBS: Including Linked Transactions (Non-GAAP)	$ 1,217,415	$ 80,062	$ 1,828,722

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For the three months ended March 31, 2014, we realized a net gain of approximately $1.3 million from the unlinking of securities previously accounted for as derivatives through linked transactions. We reclassify, from mark-to-market, adjustments on linked transactions to realized gain (loss) on linked transactions during the period the security becomes unlinked. For the three months ended March 31, 2013, we did not realize any gains or losses on unlinking of securities previously accounted for as derivatives through linked transactions.

The following table presents the vintage of our MBS investment portfolio, including linked transactions at March 31, 2014**:**

	2000	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**Total**
Agency RMBS															
20-Year Mortgage												9.5%	13.0%	2.6%	25.1%
30-Year Mortgage						0.3%			0.4%	2.2%	0.1%	35.4%	13.2%	0.8%	52.4%
Agency Interest Only- Strips			0.1%	0.1%	0.1%	0.1%		0.4%	0.3%	0.2%	0.5%	3.3%			5.1%
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives	0.3%				0.1%			0.1%		0.4%	0.2%	1.4%	0.8%		3.3%
Non-Agency RMBS		0.6%	0.4%	0.6%	3.8%	4.8%	1.7%					0.9%			12.8%
Non-Agency Linked Transactions						0.2%	0.3%								0.5%
Agency and Non-Agency CMBS						0.7%	0.1%								0.8%
Total MBS (Non-GAAP)	0.3%	0.6%	0.5%	0.7%	4.0%	6.1%	2.1%	0.5%	0.7%	2.8%	0.8%	50.5%	27.0%	3.4%	100.0%

As of March 31, 2014 the weighted average expected remaining term to the expected maturity of our investment portfolio, including linked transactions is 9.4 years.

Financing and Other Liabilities. We have entered into repurchase agreements to finance a substantial majority of our MBS. These agreements are secured by substantially all of our MBS and bear interest at rates that have historically moved in close relationship to LIBOR. The following table summarizes the fair value of MBS collateral pledged as of March 31, 2014 and December 31, 2013.

	March 31, 2014		**December 31, 2013**	
(dollars in thousands) **Collateral**	**Repurchase Agreement Borrowings Outstanding**	**Fair Value of MBS Collateral Pledged**	**Repurchase Agreement Borrowings Outstanding**	**Fair Value of MBS Collateral Pledged**
Agency RMBS	$ 2,529,527	$ 2,691,645	$ 2,331,276	$ 2,463,347
Non-Agency RMBS	279,142	392,032	230,247	332,003
Agency and Non-Agency CMBS	14,292	19,172	17,544	23,597
Total: Excluding Linked Transactions	$ 2,822,961	$ 3,102,849	$ 2,579,067	$ 2,818,947
Non-Agency RMBS Linked Transactions	12,714	15,687	61,187	79,746
Total: Including Linked Transactions (Non-GAAP)	$ 2,835,675	$ 3,118,536	$ 2,640,254	$ 2,898,693

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The following table presents our borrowing activity, by type of collateral pledged, for the three months ended March 31, 2014 and 2013:

(dollars in thousands)	For the three months ended March 31, 2014		For the three months ended March 31, 2013	
Collateral	Proceeds	Repayments	Proceeds	Repayments
Agency RMBS	$ 3,890,692	$ 3,692,442	$ 11,059,508	$ 11,879,976
Non-Agency RMBS	425,609	376,713	144,241	63,573
Agency and Non-Agency CMBS	14,292	17,544		
Total: Excluding Linked Transactions	$ 4,330,593	$ 4,086,699	$ 11,203,749	$ 11,943,549
Agency RMBS Linked Transactions				
Non-Agency RMBS Linked Transactions	38,571	87,044	47,895	4,025
Total	$ 4,369,164	$ 4,173,743	$ 11,059,508	$ 11,879,976

At March 31, 2014, we had outstanding repurchase agreement borrowings with the following 16 counterparties totaling approximately $2.8 billion, which is a Non-GAAP measure due to our Linked Transactions, which is reconciled to GAAP below as follows:

(dollars in thousands) Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Amount Outstanding	Fair Value of Company MBS Held as Collateral	Counterparty Rating(2)
Barclays Capital Inc. (1)	$ 404,287	14.3%	$ 483,532	A
Merrill Lynch Pierce Fenner & Smith Inc. (1)	388,115	13.7%	402,124	A
Deutsche Bank Securities LLC (1)	351,347	12.4%	376,524	A
JP Morgan Securities LLC (1)	298,811	10.5%	323,320	A+
Goldman Sachs Bank USA (1)	253,028	8.9%	264,143	A
BNP Paribas Securities Corporation. (1)	250,281	8.8%	268,416	A+
Credit Suisse Securities (USA) LLC (1)	186,792	6.6%	240,828	A
Mizuho Securities USA Inc. (1)	168,472	5.9%	177,145	(P)A2
UBS Securities LLC (1)	127,630	4.5%	133,370	A
RBC Capital Markets LLC (1)	101,341	3.6%	107,070	AA-
Jefferies & Company Inc. (1)	99,087	3.5%	103,673	BBB
Wells Fargo Securities LLC	98,918	3.5%	103,636	AA-
Citigroup Global Markets Inc. (1)	41,840	1.5%	54,047	A
The Royal Bank of Scotland plc(1)	27,979	1.0%	36,403	BBB+
Royal Bank of Canada (1)	25,233	0.9%	31,900	AA-
Morgan Stanley & Co. LLC	12,514	0.4%	12,405	A
Total: Non-GAAP Basis Including Linked Transactions	$ 2,835,675	100.0%	$ 3,118,536	
Linked Transactions	12,714		15,687	
Total: GAAP Basis Excluding Linked Transactions	$ 2,822,961		$ 3,102,849	

(1) Counterparty holds collateral valued in excess of 5% of our stockholders equity as security for our obligations under the applicable repurchase agreements as of March 31, 2014.

(2) The counterparty rating presented above is the long-term issuer credit rating as rated at March 31, 2014 by S&P, except for Mizuho Securities USA Inc. which is the long-term issuer credit rating by Moody s aMarch 31, 2014.

At December 31, 2013, we had outstanding repurchase agreement borrowings with the following 16 counterparties totaling approximately $2.6 billion, which is a Non-GAAP measure due to our Linked Transactions, which is reconciled to GAAP below as follows:

(dollars in thousands) Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Amount Outstanding	Fair Value of Company MBS Held as Collateral	Counterparty Rating(2)
Barclays Capital Inc. (1)	$ 362,476	13.7%	$ 414,344	A
Deutsche Bank Securities LLC (1)	356,372	13.5%	381,319	A
Goldman Sachs Bank USA (1)	306,708	11.6%	328,504	A
JP Morgan Securities LLC (1)	271,887	10.3%	313,967	A+
Citigroup Global Markets Inc. (1)	205,856	7.8%	213,358	A
Credit Suisse Securities (USA) LLC (1)	178,896	6.8%	235,680	A
Mizuho Securities USA Inc. (1)	173,030	6.6%	178,101	(P)A2
BNP Paribas Securities Corporation. (1)	152,084	5.8%	164,025	A+
Merrill Lynch Pierce Fenner & Smith Inc. (1)	142,665	5.4%	148,351	A
UBS Securities LLC (1)	130,833	5.0%	133,938	A
South Street Securities LLC (1)	100,818	3.8%	105,020	AA+
Jefferies & Company Inc. (1)	100,762	3.8%	104,302	BBB
RBC Capital Markets LLC (1)	56,222	2.1%	61,898	AA-
RBS Securities Inc. (1)	51,138	1.9%	52,625	A-
The Royal Bank of Scotland plc(1)	37,993	1.4%	50,834	BBB+
Morgan Stanley & Co. LLC	12,514	0.5%	12,427	A
Total: Non-GAAP Basis Including Linked Transactions	$ 2,640,254	100.0%	$ 2,898,693	
Linked Transactions	61,187		79,746	
Total: GAAP Basis Excluding Linked Transactions	$ 2,579,067		$ 2,818,947	

(1) Counterparty holds collateral valued in excess of 5% of our stockholders equity as security for our obligations under the applicable repurchase agreements as of December 31, 2013.

(2) The counterparty rating presented above is the long-term issuer credit rating as rated at March 12, 2014 by S&P, except for Mizuho Securities USA Inc. which is the long-term issuer credit rating by Moody s at March 12, 2014.

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We record the liability for MBS and other securities purchased, for which settlement has not taken place as an investment related payable. As of March 31, 2014, we had investment related payables of $104.5 million.

The following table presents our borrowings by type of collateral pledged as of March 31, 2014 and 2013, and the respective Effective Cost of Funds for the periods then ended (dollars in thousands):

Collateral	Balance (GAAP) March 31, 2014	Weighted Average Cost of Funds for the three months ended March 31, 2014	Balance (GAAP) March 31, 2013	Weighted Average Cost of Funds for the three months ended March 31, 2013
Agency RMBS	$ 2,529,527	0.42%	$ 3,975,546	0.44%
Non-Agency RMBS	279,142	1.71	79,384	1.86
Agency and Non-Agency CMBS	14,292	1.45		
Total	$ 2,822,961	0.53%	$ 4,054,930	0.46%

The following table presents our borrowings by type of collateral pledged as of March 31, 2014 and December 31, 2013, and the respective Effective Cost of Funds (Non-GAAP financial measure) for the periods then ended (dollars in thousands) See Non-GAAP financial measures :

Collateral	Balance (Non-GAAP) March 31, 2014	Weighted Average Effective Cost of Funds for the three months ended March 31, 2014 (1)	Balance (Non-GAAP) March 31, 2013	Weighted Average Effective Cost of Funds for the three months ended March 31, 2013 (1)
Agency RMBS	$ 2,529,527	1.74%	$ 3,975,546	0.85%
Non-Agency RMBS	279,142	1.81	79,384	1.86
Agency and Non-Agency CMBS	14,292	1.45		
Total: Excluding Linked Transactions	$ 2,822,961	1.74%	$ 4,054,930	0.86%
Non-Agency RMBS Linked Transactions	12,714	2.95	43,871	1.85
Total	$ 2,835,675	1.77%	$ 4,098,801	0.87%

(1) The effective cost of funds for the three months ended March 31, 2014 and 2013 are calculated on an annualized basis and include interest expense for the periods and net payments on interest rate swaps of approximately $7.9 million and $4.6 million, respectively and interest payments on Non-Agency linked transactions of approximately $225 thousand and $90 thousand, respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are classified as hedges for purposes of satisfying the REIT tax requirements. In addition, although certain securities and their respective repurchase borrowings are classified as derivatives, we view the interest expense attributed to these borrowings as additional cost of funds. See Non-GAAP Financial Measures.

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The following table presents our average borrowings, by type of collateral pledged, on a GAAP and Non-GAAP basis for the three months ended March 31, 2014 and 2013 (in thousands):

Collateral	For the three months ended March 31, 2014	For the three months ended March 31, 2013
Agency RMBS	$ 2,337,542	$ 4,536,108
Non-Agency RMBS	224,247	50,241
Agency and Non-Agency CMBS	14,302	
Total: Excluding Linked Transactions (GAAP)	$ 2,576,091	$ 4,586,349
Non-Agency RMBS Linked Transactions (Non-GAAP)	52,699	19,688
Total (Non-GAAP)	$ 2,628,790	$ 4,606,037
Maximum borrowings during the period (Non-GAAP)(1)	2,837,521	4,781,029

(1) Amount represents the maximum borrowings at month-end during each of the respective periods.

Derivative Instruments. As of March 31, 2014, we had entered into swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements as such repurchase agreements are renewed and/or extended. The swaps generally provide for fixed interest rates that are indexed off of LIBOR and are viewed by us to effectively fix the floating interest rates, net of variable-rate payment swaps, on approximately $2.9 billion of borrowings under our repurchase agreements, excluding forward starting swaps of $653.8 million as of March 31, 2014.

The following table presents information about our fixed pay rate interest rate swaps as of March 31, 2014 (dollars in thousands):

Remaining Interest Rate interest rate swap Term	Notional Amount	Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
1 year or less	$ 215,900	0.4%	0.6	%
Greater than 1 year and less than 3 years	729,100	0.5	1.9	
Greater than 3 years and less than 5 years	1,104,800	1.5	4.5	
Greater than 5 years	2,023,050	2.7	10.9	32.3
Total	$ 4,072,850	1.9%	7.0	16.1%

The following table presents information about our variable pay rate interest rate swaps as of March 31, 2014 (dollars in thousands):

Remaining Interest Rate interest rate swap Term	Notional Amount	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 3 years and less than 5 years	$ 281,000	0.2%	4.9	%
Greater than 5 years	246,000	0.2	12.5	

Total	$	527,000	0.2%	8.4	%

At March 31, 2014, we had entered into six swaptions with notional amounts ranging from $100.0 million to $1.5 billion which expire between May 1, 2014 and October 28, 2014. If exercised, we can enter into seven year and ten year fixed pay swap agreement with a fixed pay rate between 2.74% and 3.73%. At March 31, 2014 we had also entered into a swaption with a notional amount of $100.0 million that expires in May 1, 2014. If exercised, we can enter into a ten year variable pay swap agreement with a fixed receive rate of 3.98%.

We also purchased or sold TBAs. As of March 31, 2014 and December 31, 2013, we had contracts to purchase (long position) and sell (short position) TBAs on a forward basis. Following is a summary of our long and short TBA positions reported in Derivative assets, at fair value on the Balance Sheet as of March 31, 2014 and December 31, 2013 (dollars in thousands):

	March 31, 2014		December 31, 2013	
	Notional Amount	**Fair Value**	**Notional Amount**	**Fair Value**
Purchase contracts, asset	$ 250,000	$ 195	$ 13,600	$ 35
Sale contracts, asset	(217,000)	559		
TBA securities, asset	33,000	754	13,600	35
Purchase contracts, liability	540,000	(1,816)	176,400	(1,207)
Sale contracts, liability	(273,000)	(577)		
TBA securities, liability	267,000	(2,393)	176,400	(1,207)
TBA securities, net	$ 300,000	$ (1,639)	$ 190,000	$ (1,172)

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The following table presents additional information about our contracts to purchase and sell TBAs for the three months ended March 31, 2014 (dollars in thousands):

	Notional Amount as of December 31, 2013	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of March 31, 2014
Purchase of TBAs	$ 190,000	1,970,000	$ (1,370,000)	$ 790,000
Sale of TBAs	$	1,860,000	$ (1,370,000)	$ 490,000

We also entered into Eurodollar futures during the three months ended March 31, 2014. As of March 31, 2014, we had purchase contracts (long position), representing a notional amount of $592.0 million with an expiration date of June 2016. In addition, as of March 31, 2014, we had contracts to sell (short position), representing a notional amount of $592.0 million with an expiration date of June 2018.

Net Interest Income

We earned interest income, net of premium amortization and amortization/recovery of basis, and inclusive of discount accretion of approximately $23.4 million for the three months ended March 31, 2014 and approximately $33.8 million for the three months ended March 31, 2013 which represents interest earned on our assets. We incurred interest expense of approximately $3.4 million for the three months ended March 31, 2014 and approximately $5.2 million for the three months ended March 31, 2014, which was related to borrowings from repurchase agreements. Yields on Agency RMBS decreased in 2014 corresponding to the decrease on the yield on the ten year U.S. Treasury. Yields on Non-Agency RMBS generally decreased as result of continuing home price appreciation and market demand for such securities, however, the yield on our Non-Agency RMBS portfolio increased due higher expected recoveries and changes in the composition of such portfolio. Cost of funds remained relatively constant as the Federal Reserve continues to maintain its accommodative monetary policy.

	For the three months ended March 31, 2014				For the three months ended March 31, 2013			
(dollars in thousands)	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Total	Agency RMBS	Non-Agency RMBS	Agency and Non-Agency CMBS	Total
Average amortized cost of MBS	$ 2,554,148	$ 329,833	$ 8,871	$ 2,892,852	$ 4,560,017	$ 108,430	$	$ 4,668,447
Total interest income (1)	$ 17,713	$ 5,493	$ 224	$ 23,430	$ 32,170	$ 1,580	$	$ 33,750
Yield on average MBS	2.81%	6.75%	10.24%	3.28%	2.86%	5.91%	%	2.93%
Average balance of repurchase agreements	$ 2,337,542	$ 224,247	$ 14,302	$ 2,576,091	$ 4,536,108	$ 50,241	$	$ 4,586,349
Total interest expense	$ 2,392	$ 947	$ 51	$ 3,390	$ 4,951	$ 230	$	$ 5,181
Average cost of funds (2)	0.42%	1.71%	1.45%	0.53%	0.44%	1.86%	%	0.46%

Net interest income	$ 15,321	$ 4,546	$ 173	$ 20,040	$ 27,219	$ 1,350	$	$ 28,569
Net interest rate spread	2.39%	5.04%	8.79%	2.75%	2.42%	4.05%		2.47%

(1)Amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately $(12.1) million for Agency RMBS, approximately $738 thousand for Non-Agency RMBS, and approximately $177 thousand for Agency and Non-Agency CMBS for three months ended March 31, 2014. For the three months ended March 31, 2013, amount includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately $(18.3) million for Agency RMBS, $1.1 million for Non-Agency RMBS. In accordance with GAAP, interest income does not include $928 thousand and $435 thousand for linked transactions for the three months ended March 31, 2014 and 2013; instead such amounts are included in gain (loss) on linked transactions.

(2) For the three months ended March 31, 2014, cost of funds does not include accrual and settlement of interest associated with derivative instruments and linked transactions of approximately $7.9 million and $225 thousand, respectively. For the three months ended March 31, 2013, cost of funds does not include interest of approximately $5.8 million and $89 thousand associated with derivative instruments and linked transactions, respectively. In accordance with GAAP, such costs are included in gain (loss) on derivative instruments and gain (loss) on linked transactions, respectively, in the Statement of Operations.

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The following table sets forth certain information regarding our net investment income for the three months ended March 31, 2014 and 2013, See Non-GAAP Financial Measures :

For the three months ended March 31, 2014:

Non-GAAP Financial Measures: **(dollars in thousands)**	**Agency RMBS**	**Non-Agency RMBS**	**Agency and Non-Agency CMBS**	**Total**
Average amortized cost of MBS held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	$ 2,657,345	$ 402,105	$ 29,118	$ 3,088,568
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions(1)	$ 20,238	$ 6,460	$ 494	$ 27,192
Yield on average amortized cost of MBS including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	3.09%	6.52%	6.88%	3.57%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	$ 2,337,542	$ 276,946	$ 14,302	$ 2,628,790
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions(2)	$ 10,031	$ 1,385	$ 51	$ 11,467
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	1.74%	2.03%	1.45%	1.77%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	$ 10,207	$ 5,075	$ 443	$ 15,725
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on	1.35%	4.49%	5.43%	1.80%

interest rate swaps and linked transactions

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(1) For the three months ended March 31, 2014 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately $(18.9) million. This amount is composed of approximately $(12.1) million for Agency RMBS included in interest income, approximately $738 thousand for Non-Agency RMBS included in interest income, approximately $177 thousand for Agency and Non-Agency CMBS included in interest income, approximately $(2.2) million for Non-Agency linked transactions (Non-GAAP measure) and approximately $(5.6) million of amortization/recovery of basis on Agency and Non-Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

(2) Represents the net amount paid, including accrued amounts, for interest rate swaps during the period, included in loss on derivative instruments for GAAP and interest expense on linked transactions.

For the three months ended March 31, 2013:

Non-GAAP Financial Measures: **(dollars in thousands)**		**Agency RMBS**		**Non-Agency RMBS**		**Agency and Non-Agency CMBS**		**Total**
Average amortized cost of MBS held including Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions	$	4.649.118	$	142,239	$		$	4,791,357
Total interest income including interest income on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions(1)	$	33,929	$	2,015	$		$	35,944
Yield on average amortized cost of MBS including adjustments related to cost of Agency and Non-Agency Interest-Only Strips accounted for as derivatives and linked transactions		2.96%		5.75%				3.04%
Average balance of repurchase agreements, including repurchase agreements on linked transactions	$	4,536,108	$	69,929	$		$	4,606,037
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions(2)	$	9,533	$	320	$		$	9,853
Average cost of funds including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		0.85%		1.86%				0.87%
Net interest income including interest income (expense) on Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	$	24,396	$	1,695	$		$	26,091
Net interest rate spread including interest income (expense) on Agency and Non-Agency Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		2.11%		3.89%				2.17%

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(1) For the three months ended March 31, 2013 includes net (amortization of premiums), accretion of discounts and (amortization/recovery of basis) of approximately $(21.1) million. This amount is composed of approximately $(18.3) million for Agency RMBS included in interest income, approximately $1.1 million for Non-Agency RMBS included in interest income, approximately $0.3 million for linked transactions (Non-GAAP measure) and approximately $(4.2) million of amortization/recovery of basis on Agency Interest-Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

(2) Represents the net amount paid, including accrued amounts, for interest rate swaps during the period, included in loss on derivative instruments for GAAP and interest expense on linked transactions.

Interest income is subject to interest rate risk. Refer to Item 7A, Quantitative and Qualitative Disclosures about Market Risk, for more information relating to interest rate risk and its impact on our operating results.

Other Income (Loss)

The following tables present the sales of our MBS (dollars in thousands):

	For the three months ended March 31, 2014			
	Proceeds	**Gross Gains**	**Gross Losses**	**Net Gain (Loss)**
Agency RMBS (1)	$ 13,287	$ 16	$ (869)	$ (853)
Non-Agency RMBS	103,176	4,235	(535)	3,700
Total	$ 116,463	$ 4,251	$ (1,404)	$ 2,847

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately $11.2 million and gross realized losses of approximately $869 thousand.

	For the three months ended March 31, 2013			
	Proceeds	**Gross Gains**	**Gross Losses**	**Net Gain (Loss)**
Agency RMBS(1)	$ 1,828,722	$ 8,646	$ (20,405)	$ (11,759)
Total	$ 1,828,722	$ 8,646	$ (20,405)	$ (11,759)

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately $8.4 million and gross realized losses of approximately $99 thousand.

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The MBS market remains a dynamic and, at times, volatile market. Our Manager regularly reviews the characteristics of our portfolio and may make changes to our portfolio in order to adjust such portfolio characteristics in response to and/or anticipation of changing market conditions. Accordingly, due to changes in market conditions or expected changes in market conditions, we sold these MBS in order to adjust the overall characteristics of our portfolio including, but not limited to, prepayment expectations and duration.

With respect to our MBS, we elected the fair value option and, as a result, we record the change in fair value related to MBS in earnings. The following tables present amounts related to realized gains and losses as well as changes in fair value of our MBS portfolio and derivative instruments that are included in our statement of operations for three months ended March 31, 2014 and 2013:

For the three months ended March 31, 2014:

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Other loss on Mortgage -backed securities	Unrealized Gain (Loss), net	Basis Recovery	Mark-to-market adjustments	Total
MBS and Other Securities	$ 3,716	$	$ (1,709)	$ 31,091	$	$	$ 33,098
Cash and cash equivalents		(12)					(12)
Derivative Instruments:							
Interest rate swaps	2	(7,853)				(45,496)	(53,347)
Interest rate swaptions						(9,324)	(9,324)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(869)	8,426			(5,592)	(1,220)	745
Futures contracts						118	118
TBAs	2,370					(468)	1,902
Linked Transactions	1,290	2,753			(2,050)	226	2,219
Total	$ 6,509	$ 3,314	$ (1,709)	$ 31,091	$ (7,642)	$ (56,164)	$ (24,601)

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received. In addition, contractual interest income (expense), net on linked transactions includes amortization of approximately $122 thousand for Non-Agency RMBS.

For the three months ended March 31, 2013:

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Other loss on Mortgage -backed securities	Unrealized Gain (Loss), net	Basis Recovery	Mark-to-market adjustments	Total
MBS and Other Securities	$ (11,660)	$	$ (2,268)	$ (54,759)	$	$	$ (68,687)

Cash and cash equivalents		33					33
Derivative Instruments:							
Interest rate swaps	18,258	(4,582)				1,858	15,534
Interest rate swaptions						(1,506)	(1,506)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(99)	5,943			(4,185)	(2,348)	(689)
Options						(324)	(324)
TBAs	601					1,224	1,825
Linked Transactions		346				250	596
Total	$ 7,100	$ 1,740	$ (2,268)	$ (54,759)	$ (4,185)	$ (846)	$ (53,218)

(1) Contractual interest income (expense), net on derivative instruments includes interest settlement paid or received. In addition, contractual interest income (expense), net on linked transactions includes accretion of approximately $329 thousand for Non-Agency RMBS.

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In order to mitigate interest rate risk resulting from our future repurchase agreement borrowings, we entered into interest rate swaps with an aggregate notional amount of approximately $4.6 billion, of which $653.8 million are forward starting. Our effective swaps are comprised of approximately $3.4 billion fixed pay rate swaps and $527.0 million are variable pay swaps, which effectively fix (for the life of the swap) the floating interest rate of approximately $2.9 billion and interest rate swaptions with an aggregate notional amount of approximately $2.1 billion at March 31, 2014. While not designated as a hedge for accounting purposes, our current and future interest rate swaps and interest rate swaptions are viewed as an economic hedge on a portion of our floating-rate borrowings. Since we do not apply hedge accounting for our interest rate swaps, we record the change in fair value related to such agreements in earnings as unrealized gain (loss) on derivative instruments. Included in realized gain or loss on derivative instruments are the net interest rate swap payments (including accrued amounts) associated with our interest rate swaps.

Expenses

General and Administrative Expenses

We incurred general and administrative expenses of approximately $2.1 million and $1.7 million for the three months ended March 31, 2014 and 2013, respectively, which represents professional fees, insurance, non-cash stock based compensation and overhead costs of the Company. The increase in general and administrative expenses from 2014 over 2013 is primarily due to an increase in stock-based compensation costs.

Management Fee Expense

We incurred management fee expense of approximately $1.8 million and $2.1 million for the three months ended March 31, 2014 and 2013, respectively, of which approximately $1.8 million was payable at March 31, 2014 to our Manager under the Management Agreement. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. Management fees primarily decreased from 2014 over 2013 due to a decrease in our stockholder s equity, as adjusted for non-cash items.

The management fees, expense reimbursements and the relationship between our Manager and us are discussed further in Note 9, Related Party Transactions, to the financial statements contained in this Quarterly Report on Form 10-Q.

Dividends

The following table presents cash dividends declared and paid by us on our common stock:

Declaration Date	Record Date	Payment Date	Amount per Share	Tax Characterization

2014					
March 20, 2014	March 31, 2014	April 29, 2014	$	0.67	Not yet determined
2013					
April 1, 2013	April 12, 2013	April 30, 2013	$	0.95	Ordinary income
June 20, 2013	July 1, 2013	July 29, 2013	$	0.90	Ordinary income
September 19, 2013	September 30, 2013	October 29, 2013	$	0.90	Ordinary income
December 19, 2013	December 30, 2013	January 28, 2014	$	2.35(1)	Ordinary income

(1) Consisting of cash and stock. For stockholders who elected to receive the entire $2.35 per share dividend in stock, each stockholder received 0.1590 shares in newly issued shares of our common stock for each common share that they held as of the dividend record date. For stockholders who elected to receive the dividend in cash, or did not make an election, each stockholder received $0.9159 per share in cash and 0.0970 shares in newly issued shares of our common stock for each common share that they held as of the dividend record date.

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Subsequent Events

Follow-On Offering and Private Placement

On April 9, 2014, we completed a follow-on public offering of 13,000,000 shares of our common stock and a private placement of 650,000 shares of our common stock with our Manager. The combined net proceeds from the public offering and private placement were approximately $200.0 million, after deducting the underwriting discount and estimated offering expenses payable by us. On May 2, 2014, underwriters from the April stock offering notified us that they had elected to exercise a portion of the overallotment option and purchase an additional 1,000,000 shares of common stock from us providing us with incremental proceeds of approximately $14.7 million, which were received on May 7, 2014.

As a result of the April 9, 2014 follow-on public offering of common stock, the exercise price of each of the outstanding warrants was reduced from $17.59 to $16.70.

Liquidity and Capital Resources

General

Our liquidity and capital resources are managed on a daily basis to ensure that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls and to ensure that we have the flexibility to manage our investment portfolio to take advantage of market opportunities.

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations make distributions to our stockholders, and other general business needs. We use cash to purchase our target assets, repay principal and interest on our borrowings, make distributions to our stockholders and fund our operations.

Under our repurchase agreements and derivative contracts, lenders and counterparties retain the right to determine the fair value of the collateral pledged, or in the case of cleared swaps the required collateral may be determined by clearinghouse rules. A reduction in the value of the collateral pledged will require us to provide additional collateral or fund cash margin calls. Alternatively, since margins calls for our interest rate swaps and swaptions generally are inversely correlated to those of our repurchase agreements, our interest rate swap and swaptions counterparties would likely be required to post collateral with us during a period in which we were required to post collateral with our repurchase agreement counterparties. During 2013, the fixed income markets experienced volatility and, in particular, the sell-off in Agency RMBS that occurred between the beginning of July 2013 and the Federal Reserve postponing its decision to taper in September 2013, resulted in demands for additional collateral from our repurchase agreement counterparties. Similarly, we received incremental collateral from our interest rate swap and swaption counterparties during this time. We were able to satisfy our additional collateral requirements with unpledged securities in our portfolio, cash on hand and cash received as and with respect to incremental collateral received on our interest rate swaps and swaptions. We were not forced to involuntarily sell any of our assets, nor did any of counterparties sell any of assets held by them as collateral. During the

second and third quarters of 2013, we rehypothecated some of the securities we received as incremental collateral on our swaps and swaptions, effectively entering into repurchase agreements with such securities, in order to increase our cash position. At December 31, 2013, no securities were rehypothecated. During the first quarter of 2014, we were able to satisfy our additional collateral requirements pertaining to our swaps and swaptions with cash on hand and proceeds of our repurchase agreement borrowings. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

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As part of our risk management process, our Manager closely monitors our liquidity position. This includes the development and evaluation of various alternative processes and procedures, which continue to be updated with regard to scenario testing for purposes of assessing our liquidity in the face of different economic and market developments. We believe we have sufficient current liquidity and access to additional liquidity to meet financial obligations for at least the next 12 months.

Our primary sources of liquidity are as follows:

Borrowing under Various Financing Arrangements

As of March 31, 2014, we had master repurchase agreements with 20 counterparties. We had borrowings under repurchase agreements with 16 counterparties of approximately $2.8 billion at March 31, 2014. The following tables present our borrowings by type of collateral pledged as of March 31, 2014 and 2013, and the respective effective cost of funds (Non-GAAP financial measure) for the three months ended March 31, 2014 and 2013. See   Non-GAAP Financial Measures   (dollars in thousands):

Collateral	Repurchase Agreement Borrowings Outstanding March 31, 2014	Fair Value of Collateral Pledged (1)	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for three months ended March 31, 2014	Weighted Average Effective Cost of Funds (Non-GAAP) for the for the three months ended March 31, 2014 (2)
Agency RMBS	$ 2,529,527	$ 2,691,645	0.39%	0.42%	1.74%
Non-Agency RMBS	279,142	392,032	1.69	1.71	1.81
Agency and Non-Agency CMBS	14,292	19,172	1.43	1.45	1.45
Total: Excluding Linked Transactions	$ 2,822,961	$ 3,102,849	0.52%	0.53%	1.74%
Non-Agency RMBS Linked Transactions	12,714	15,687	1.56	n/a	2.95
Total (Non-GAAP)	$ 2,835,675	$ 3,118,536	0.53%	0.53%	1.77%

(1) Excludes approximately $11.1 million of cash collateral posted.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net payments on interest rate swaps of approximately $7.9 million and interest expense on linked transactions of approximately $225 thousand. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates on our liabilities and are treated as hedges for purposes of satisfying the REIT tax requirements. See   Non-GAAP Financial Measures .

Collateral	Repurchase Agreement Borrowings Outstanding	Fair Value of Collateral Pledged (1)	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the three months ended March 31,	Weighted Average Effective Cost of Funds for the for the three months

	March 31, 2013			2013	ended March 31, 2013 (2)
Agency RMBS	$ 3,975,546	$ 4,211,798	0.42%	0.44%	0.85%
Non-Agency RMBS	79,384	129,737	1.84	1.86	1.86
Total: Excluding Linked Transactions	$ 4,054,930	$ 4,341,535	0.45%	0.46%	0.86%
Linked Transactions	43,871	66,715	1.79	n/a	1.85
Total	$ 4,098,801	$ 4,408,250	0.47%	0.46%	0.87%

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(1) Excludes approximately $18.3 million of cash collateral posted.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net payments on interest rate swaps of approximately $4.6 million and interest expense on linked transactions of $90 thousand. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates and are treated as hedges for purposes of satisfying the REIT tax requirements. See Non-GAAP Financial Measures .

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As of March 31, 2014, our repurchase agreements with 20 counterparties, require collateral in excess of the loan amount, or haircuts, ranging from a low of 3.0% to a high of 5.5% for Agency RMBS, exclusive of IOs and IIOs for which the haircuts are as high as 30.0% and for Non-Agency RMBS and Agency and Non-Agency CMBS for which the haircuts range from a low of 10.0% to a high of 45.0%. Declines in the value of our portfolio can trigger margin calls by our lenders under our repurchase agreements. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all existing repurchase transactions with us and require any amount due to the counterparties by us to be payable immediately. In which case, we may be forced to sell assets under adverse market conditions or through foreclosure which may have a material adverse consequence on our business, financial position, our results of operations and cash flows. During the three months ended March 31, 2014, we were able to satisfy margin calls using cash on hand, unlevered or underleveraged securities, and cash from our repurchase agreement borrowings. No event of default occurred.

Under the repurchase agreements and derivative contracts, the respective lenders and counterparties, subject to the terms of the individual agreements and in the case of cleared swaps, the clearinghouse rules, retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires us to provide additional collateral or fund margin calls. In addition, certain of the repurchase agreements may be terminated by our counterparties if we do not maintain certain equity and leverage metrics. We are compliant with these tests at March 31, 2014. At March 31, 2014, MBS held by counterparties as security for repurchase agreements totaled approximately $3.1 billion, inclusive of MBS posted of $15.7 million for repurchase agreements accounted for as linked transactions. At December 31, 2013, MBS held by counterparties as security for repurchase agreements totaled approximately $2.9 billion, inclusive of MBS posted of $79.7 million for repurchase agreements accounted for as linked transactions.

We are also required to pledge cash or securities as collateral as part of a margin arrangement, calculated daily, in connection with the swaps and swaptions. The amount of margin that we are required to post will vary and generally reflects collateral posted with respect to swaps that are in an unrealized loss position to us and a percentage of the aggregate notional amount of swaps per counterparty as well as margin posted with our clearing broker, pursuant to clearinghouse rules and practices, for cleared swaps. Conversely, if our bilateral swaps and swaptions are in an unrealized gain position, our counterparties are required to post collateral with us, under the same terms that we post collateral with them.

Cash collateral held by counterparties at March 31, 2014 was approximately $57.8 million, which is included in Due from counterparties on our Balance Sheet, comprised of approximately $11.1 million held in connection with repurchase borrowings, approximately $225 thousand held in connection with our futures contracts and approximately $46.5 million held by our interest rate swap counterparties. At March 31, 2014, Due to counterparties on our Balance Sheet was comprised of approximately $4.5 million posted with us by our repurchase agreement counterparties and approximately $29.5 million posted by our interest rate swap and swaption counterparties. Cash collateral held by counterparties at December 31, 2013 was approximately $55.4 million, which is included in Due from counterparties on our Balance Sheet, comprised of approximately $32.6 million held in connection with repurchase borrowings and approximately $22.8 million held by our interest rate swap counterparties. At December 31, 2013, Due to counterparties on our Balance Sheet was comprised of approximately $3.2 million posted with us by our repurchase agreement counterparties and approximately $62.7 million posted by our interest rate swap and swaption counterparties.

We had approximately $104.5 million and $0, respectively of unsettled purchased securities as of March 31, 2014 and December 31, 2013, included in Investment related payables on our Balance Sheet. In addition, we had approximately $2.4 million and $0, respectively unsettled sold securities as of March 31, 2014 and December 31, 2013, included in Investment related receivables on our Balance Sheet.

Cash Generated from Operations

For the three months ended March 31, 2014, operating activities increased our cash balance by approximately $11.5 million. This was primarily attributable to the net interest income we earned on our investments for the three months net of adjustments pertaining to the amortization/accretion of premiums and discounts, which are non-cash items. For the three months ended March 31, 2013, operating activities increased our cash balance by approximately $52.2 million. This was primarily attributable to the net interest income we earned on our investments net of adjustments pertaining to the amortization/accretion of premiums and discounts, which are non-cash items, and cash received on termination of interest rate swaps.

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Cash Provided by and Used in Investing Activities

For the three months ended March 31, 2014, our investing activities decreased our cash balance by approximately $196.3 million. This was primarily attributable to our cash expenditures to acquire MBS, partially offset by proceeds from sales of MBS. For the three months ended March 31, 2013, investing activities increased our cash balance by approximately $609.4 million. This was primarily attributable to proceeds from sale of MBS, offset by capital expenditures to acquire MBS.

Cash Provided by and Used in Financing Activities

For the three months ended March 31, 2014, our financing activities increased our cash balance by approximately $141.7 million. This was primarily attributable to an increase in our net borrowings under repurchase agreements. For the three months ended March 31, 2013, financing activities reduced our cash balance by approximately $713.9 million. This was primarily attributable to a decrease in our net borrowings under repurchase agreements.

Other Potential Sources of Financing

We held cash of approximately $5.5 million and $3.9 million at March 31, 2014 and 2013, respectively. Our primary sources of cash currently consist of repurchase facility borrowings, investment income and the proceeds of any future securities offering, to the extent available in the capital market. In the future, we expect our primary sources of liquidity to consist of payments of principal and interest we receive on our portfolio of assets, unused borrowing capacity under our financing sources and future issuances of equity and debt securities.

To maintain our qualification as a REIT under the Code, we must distribute annually at least 90% of our taxable income. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital for operations. We believe that our significant capital resources and access to financing will provide us with financial flexibility at levels sufficient to meet current and anticipated capital requirements, including funding new investment opportunities, paying distributions to our stockholders and servicing our debt obligations.

Contractual Obligations and Commitments

Our contractual obligations as of March 31, 2014 are as follows (dollars in thousands):

	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years	Total
	$ 2,835,675				$ 2,835,675

Borrowings under repurchase agreements (including linked transactions)				
TBA long positions		829,694		829,694
Total: Non-GAAP Basis Including Linked Transactions		3,665,369		3,665,369
Linked Transactions		12,714		12,714
TBA long positions		829,694		829,694
Total: GAAP Basis Excluding Linked Transactions and TBA-long positions	$	2,822,961	$	2,822,961

We enter into a linked transaction when the initial transfer of a financial asset and repurchase financing are entered into contemporaneously with, or in contemplation of, one another. In this situation, we then record the initial transfer and repurchase financing on a net basis. The fair value of linked transactions reflects the value of the underlying real estate securities and linked repurchase agreement borrowings; resulting in an embedded repurchase agreement. As of March 31, 2104, we had two linked transactions resulting in approximately $12.7 million of embedded repurchase agreements with a weighted average rate of 1.56%. The weighted average contractual maturity of the repurchase agreements for linked transactions was 17 days.

As of March 31, 2014, we have an obligation for approximately $3.0 million in contractual interest payments related to our repurchase agreements, including linked transactions of approximately $18 thousand through the respective maturity date of each repurchase agreement.

The table above does not include amounts due under the Management Agreement (as defined herein) with our Manager, as those obligations do not have fixed and determinable payments. For a description of the Management Agreement, see Our Manager and the Management Agreement the Management Agreement.

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On May 9, 2012, we entered into a management agreement (the Management Agreement) with our Manager which describes the services to be provided by our Manager and compensation for such services. Our Manager is responsible for managing our operations, including: (i) performing all of our day-to-day functions; (ii) determining investment criteria in conjunction with our board of directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of our board of directors. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.50% per annum of our stockholders equity, (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders equity means the sum of the net proceeds from any issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of our shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges included in other loss on MBS, unrealized gain (loss) on MBS and other securities and the non-cash portion of gain (loss) on derivative instruments, that have impacted stockholders equity as reported in our financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between our Manager and our independent directors and after approval by a majority of our independent directors. However, if our stockholders equity for any given quarter is negative based on the calculation described above, our Manager will not be entitled to receive any management fee for that quarter.

In addition, under the Management Agreement, we are required to reimburse our Manager for the expenses described below. Expense reimbursements to the Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation. Because our Manager s personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, our Manager may be paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm s-length basis. Commencing January 1, 2014, our chief financial officer is now an employee of the Manager. Accordingly, we will reimburse our Manager for his compensation and benefits. For the three months ended March 31, 2014 and 2013, we recorded expenses, paid by the Manager on our behalf, totaling approximately $210 thousand and $9 thousand, respectively, related to employee costs and benefits associated with our chief financial officer.

The Management Agreement may be amended, supplemented or modified by agreement between our Manager and us. The initial term of the Management Agreement expires on May 15, 2015 and it is automatically renewed for one-year terms on each anniversary thereafter unless previously terminated as described below. Our independent directors will review the Manager s performance and any fees payable to the Manager annually and, following the initial term, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds (2/3) of our independent directors, based upon: (i) our Manager s unsatisfactory performance that is materially detrimental to us; or (ii) our determination that any fees payable to our Manager are not fair, subject to our Manager s right to prevent such termination due to unfair fees by accepting a reduction of management fees agreed to by at least two-thirds (2/3) of our independent directors. We will provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we will pay the Manager a termination fee equal to three times the average annual management fee earned by the Manager during the prior 24-month period immediately preceding the date of termination, calculated as of the end of the most recently completed fiscal quarter prior to the date of termination.

We may also terminate the Management Agreement at any time, including during the initial term, without the payment of any termination fee, with 30 days prior written notice from our board of directors for cause, which will be determined by a majority of our independent directors, which is defined as: (i) our Manager s continued material breach of any provision of the Management Agreement (including our Manager s failure to comply with our investment guidelines); (ii) our Manager s fraud, misappropriation of funds, or embezzlement against us; (iii) the Manager s gross negligence in the performance of its duties under the Management Agreement; (iv) the occurrence of certain events with respect to the bankruptcy or insolvency of our Manager, including an order for relief in an involuntary bankruptcy case or our Manager authorizing or filing a voluntary bankruptcy petition; (v) our Manager is convicted (including a plea of nolo contendere) of a felony; or (vi) the dissolution of our Manager.

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Off-Balance Sheet Arrangements

Our linked transactions are comprised of real estate securities and associated repurchase agreements. The extent to which these transactions become unlinked in the future, the underlying real estate securities and the borrowings under repurchase agreements and associated interest income and expense will be presented on a gross basis on our balance sheet and statement of operations, prospectively. As of March 31, 2014, our maximum exposure to loss on linked transactions was approximately $3.0 million.

As of March 31, 2014, we held contracts to purchase (long position) and sell (short position) TBAs on a forward basis. If a counterparty to one of the TBAs that we enter into defaults on its obligations, we may not receive payments or securities due under the TBA agreement, and thus, we may lose any unrealized gain associated with that TBA transaction.

We do not have any relationships with any entities or financial partnerships, such as entities often referred to as structured investment vehicles, or special purpose or variable interest entities, established to facilitate off-balance sheet arrangements or other contractually narrow or limited purposes.

Further, we have not guaranteed any obligations of any entities or entered into any commitment to provide additional funding to any such entities.

See Warrants above for a description of our outstanding warrants.

Dividends

We intend to make regular quarterly dividend distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually, in accordance with the REIT regulations, at least 90% of its REIT taxable income for the taxable year, without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates to the extent that it annually, in accordance with the REIT regulations, distributes less than 100% of its net taxable income. We intend to pay regular quarterly dividends to our stockholders based on our net taxable income, if and to the extent authorized by our board of directors. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debts payable. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

On March 20, 2014, we declared a regular quarterly dividend of $0.67 per common share for the quarter ended March 31, 2014. The dividend was paid on April 29, 2014 to shareholders of record as of March 31, 2013.

Non-GAAP Financial Measures

Total Interest Income and Net Interest Income, including Interest Income on Agency Interest-Only accounted for as derivatives and Effective Cost of Funds

Total interest income including interest income on Agency Interest-Only Strips classified as derivatives and Effective Cost of Funds for the three months ended March 31, 2014 and 2013, constitutes a Non-GAAP financial measure within the meaning of Regulation G promulgated by the SEC. We believe that the measures presented in this quarterly report on Form 10-Q, when considered together with U.S. GAAP financial measures, provide information that is useful to investors in understanding our borrowing costs and net interest income, as viewed by us. An analysis of any Non-GAAP financial measure should be made in conjunction with results presented in accordance with GAAP.

For purposes of evaluating operating results, we believe it useful to present investors with additional information pertaining to the net interest margin generated by our portfolio. Net interest margin is gross interest, adjusted for amortization/accretion of bond premium/discount, less interest expense or financing cost. GAAP requires that certain of our IO and IIO securities be treated as derivatives and, accordingly, the interest income associated with these securities be included with Gain (loss) on derivative instruments, net in our Statement of Operations. Similarly, GAAP requires that interest income on linked transactions be included in Gain (loss) on linked transactions, net in our Statement of Operations. Accordingly, in order to determine the gross interest income generated by our IO and IIO securities which are classified as derivatives and our MBS securities which are classified as linked transactions, we calculate the interest income on these securities as if they were not derivatives or linked transactions.

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The following table reconciles total interest income to interest income including interest income on Agency and Non- Agency Interest-Only Strips classified as derivatives and interest income on linked transactions (Non-GAAP financial measure) for the three months ended March 31, 2014 and 2013:

(in thousands)	For the three months ended March 31, 2014		For the three months ended March 31, 2013	
Coupon Interest	$	34,578	$	51,001
Premium accretion, discount amortization and amortization of basis, net		(11,148)		(17,251)
Interest Income	$	23,430	$	33,750
Contractual Interest income, net of amortization basis on Agency and Non-Agency Interest-Only and Interest Strips, classified as derivatives(1):				
Coupon Interest	$	8,426	$	5,943
Amortization of basis (Non-GAAP Financial Measure)		(5,592)		(4,184)
Contractual Interest income, net of discount amortization on Linked Transactions (2):				
Coupon Interest		3,100		106
Discount amortization		(2,172)		329
Subtotal		3,762		2,194
Total interest income, including interest income on Agency and Non-Agency Interest-Only Strips, classified as derivatives - Non-GAAP Financial Measure	$	27,192	$	35,944

(1) Reported in gain (loss) on derivative instruments in the Statement of Operations.

(2) Reported in gain (loss) on linked transactions in the Statement of Operations.

Effective Cost of Funds includes the net interest component related to our interest rate swaps and borrowings under linked transactions. While we have not elected hedge accounting for our interest rate swaps, such derivative instruments are viewed by us as an economic hedge against increases in future market interest rates on our liabilities and are characterized as hedges for purposes of satisfying the REIT tax requirements and therefore the Effective Cost of Funds reflects interest expense adjusted to include the realized loss (i.e., the interest expense component) for all of our interest rate swaps. In addition, our linked transactions are comprised of real estate securities, associated with repurchase agreements. We view the cost of the associated repurchase agreements (interest expense) as a component of our Effective Cost of Funds.

The following table reconciles the Effective Cost of Funds (Non-GAAP financial measure) with interest expense for the three months ended March 31, 2014 and 2013:

(dollars in thousands)	For the three months ended March 31, 2014			For the three months ended March 31, 2013		
	Reconciliation		Cost of Funds/Effective Borrowing Costs	Reconciliation		Cost of Funds/Effective Borrowing Costs
Interest expense	$	3,390	0.53%	$	5,181	0.46%

Interest expense on linked transactions		225	1.73%	90	1.85%
Net interest paid - interest rate swaps		7 852	1.21%	4,582	0.41%
Effective Borrowing Costs	$	11 ,467	1.77% $	9,853	0.87%
Weighted average repurchase borrowings (1)		2,628,790		4,606,037	

(1) Includes average repurchase borrowings under linked transactions.

Core Earnings

Our Core Earnings were approximately $12.4 million and approximately $22.6 million for the three months ended March 31, 2014 and 2013, respectively. Core Earnings is a Non-GAAP financial measure that is used by us to approximate cash yield or income associated with our portfolio and is defined as GAAP net income (loss) as adjusted, excluding: (i) net realized gain (loss) on investments and derivative contracts; (ii) net unrealized gain (loss) on investments; (iii) net gain (loss) resulting from mark-to-market adjustments on derivative contracts; (iv) other loss on MBS; (v) non-cash stock-based compensation expense; and (vi) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the us, the Manager and our independent directors and after approval by a majority of the our independent directors.

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In order to evaluate the effective yield of the portfolio, we use Core Earnings to reflect the net investment income of our portfolio as adjusted to reflect the net interest rate swap interest income (expense). Core Earnings allows us to isolate the interest income (expense) associated with our interest rate swaps in order to monitor and project our borrowing costs and interest rate spread. In addition, we utilize Core Earnings as a key metric in conjunction with other portfolio and market factors to determine the appropriate leverage and hedge ratios, as well as the overall structure of the portfolio. We also believe that our investors use Core Earnings or a comparable supplemental performance measure to evaluate and compare our performance and our peers, and as such, we believe that the disclosure of Core Earnings is useful to our investors.

Our presentation of Core Earnings may not be comparable to similarly-titled measures of other companies, who may use different calculations. As a result, Core Earnings should not be considered as a substitute for our GAAP net income as a measure of our financial performance or any measure of our liquidity under GAAP.

The table below reconciles Net Loss to Core Earnings for the three months ended March 31, 2014 and 2013:

(dollars in thousands)	**For the three months ended March 31, 2014**	**For the three months ended March 31, 2013**
Net Loss GAAP	$ (8,441)	$ (28,499)
Adjustments:		
MBS and other securities:		
Unrealized (gain) loss on MBS	(31,091)	54,759
Other loss on mortgage-backed securities	1,709	2,268
Realized (gain) loss on sale of MBS	(3,716)	11,660
Derivative Instruments:		
Realized gain on termination of interest rate swaps	(2)	(18,258)
Realized gain on settlement of TBAs	(2,370)	(601)
Realized gain on sale/unlinking of securities underlying linked transactions	(1,290)	
Realized loss on Agency Interest-Only Strips accounted for as derivatives	869	99
Mark-to-market adjustments on interest rate swaps	45,496	(1,858)
Mark-to-market adjustments on interest rate swaptions	9,324	1,506
Mark-to-market adjustments on options		324
Mark-to-market adjustments on futures contracts	(118)	
Mark-to-market adjustments on TBAs	468	(1,224)
Mark-to-market adjustments on linked transactions	(226)	(250)
Mark-to-market adjustments on derivative instruments	1,220	2,348
Non-cash stock-based compensation expense	588	286
Total adjustments	20,861	51,059
Core Earnings Non-GAAP Financial Measure	$ 12,420	$ 22,560
Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure	$ 0.46	$ 0.93
Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure	$ 0.46	$ 0.93

Basic weighted average common shares and participating securities	26,907,391	24,206,170
Diluted weighted average common shares and participating securities	26,907,391	24,338,990

Alternatively, our Core Earnings can also be derived as presented in the table below by starting with Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps (a Non-GAAP financial measure) subtracting Operating Expenses, net of Non-cash stock based compensation, and adding Interest income on cash balances and other income (loss), net:

(dollars in thousands)	**For the three months ended March 31, 2014**	**For the three months ended March 31, 2013**
Net interest income including interest income on Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps (a Non-GAAP financial measure)	$ 15,724	$ 26,091
Total Operating Expenses	(3,880)	(3,850)
Non-cash stock based compensation	588	286
Interest income on cash balances and other income (loss), net	(12)	33
Core Earnings (a Non-GAAP) financial measure	$ 12,420	$ 22,560

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ITEM 3. Quantitative and Qualitative Disclosures about Market Risk.

We seek to manage the risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market values while, at the same time, seeking to provide an opportunity to stockholders to realize attractive risk-adjusted returns from our assets through ownership of our common stock. While we do not seek to avoid risk completely, our Manager seeks to actively manage risk for us, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

Credit Risk

We are subject to varying degrees of credit risk in connection with our assets. Although we do not expect to encounter credit risk in our Agency MBS, we do expect to encounter credit risk related to Non-Agency MBS and Non-Agency CMBS. Investment decisions are made following a bottom-up credit analysis and specific risk assumptions. As part of the risk management process, our Manager uses detailed proprietary models to evaluate, depending on the asset class, house price appreciation and depreciation by region, prepayment speeds and foreclosure frequency, cost and timing. If our Manager determines that the proposed investment can meet the appropriate risk and return criteria as well as complement our existing asset portfolio, the investment will undergo a more thorough analysis.

As of March 31, 2014, 15 of the counterparties that we had outstanding repurchase agreement borrowings held collateral which we posted as security for such borrowings in excess of 5% of our Stockholders equity. Prior to entering into a repurchase agreement with any particular institution, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

Interest Rate Risk

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations. In general, we expect to finance the acquisition of our assets through financings in the form of repurchase agreements, warehouse facilities, securitizations, resecuritizations, bank credit facilities (including term loans and revolving facilities) and public and private equity and debt issuances in addition to transaction or asset specific funding arrangements. Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. We also may engage in a variety of interest rate management techniques that seek to mitigate changes in interest rates or other potential influences on the values of our assets.

Interest Rate Effect on Net Interest Income

Our operating results will depend in large part on differences between the income earned on our assets and our borrowing costs. The cost of our borrowings is generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase and the yields earned on our leveraged fixed-rate mortgage assets will remain static. Further, the cost of such financing could increase at

a faster pace than the yields earned on our leveraged ARM and hybrid ARM assets. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

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Interest Rate Cap Risk

To the extent we invest in adjustable-rate RMBS, such securities are generally subject to interest rate caps, which potentially could cause such RMBS to acquire many of the characteristics of fixed-rate securities if interest rates were to rise above the cap levels. This issue is magnified to the extent we acquire ARM and hybrid ARM assets that are not based on mortgages which are fully indexed. In addition, ARM and hybrid ARM assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding or a portion of the incremental interest rate increase being deferred. To the extent we invest in such ARM and/or hybrid ARM assets, we could potentially receive less cash income on such assets than we would need to pay the interest cost on our related borrowings. To mitigate interest rate mismatches, we may utilize the hedging strategies discussed above under Interest Rate Risk.

Interest Rate Effects on Fair value

Another component of interest rate risk is the effect that changes in interest rates will have on the market value of the assets that we acquire. We face the risk that the market value of our assets will increase or decrease at different rates than those of our liabilities, including our hedging instruments. See Market Risk below.

The impact of changing interest rates on fair value can change significantly when interest rates change materially. Therefore, the volatility in the fair value of our assets could increase significantly in the event interest rates change materially. In addition, other factors impact the fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, changes in actual interest rates may have a material adverse effect on us.

Market Risk

Market value risk. Our MBS are reflected at their fair value with unrealized gains and losses included in earnings. The fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the fair value of these securities would be expected to decrease; conversely, in a decreasing interest rate environment, the fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments, including interest rate swaps, Interest-Only Strips, and net interest income at March 31, 2014, assuming a static portfolio of assets. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager s expectations. The analysis presented utilizes our Manager s assumptions, models and estimates, which are based on our Manager s judgment and experience.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
+1.00%	16.60%	(0.64)%

+0.50%	10.86%	(0.48)%
-0.50%	(16.38)%	0.24%
-1.00%	NA(1)	NA(1)

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(1) Not applicable, borrowing rate is below zero.

(2) Includes linked real estate securities that are reported as a component of linked transactions in our balance sheets. Such securities may not be linked in future periods.

While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we may rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and derivative instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above and such difference might be material and adverse to our stockholders.

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Certain assumptions have been made in connection with the calculation of the information set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at March 31, 2014. The analysis presented utilizes assumptions and estimates based on our Manager s judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk, future purchases and sales of assets could materially change our interest rate risk profile.

Prepayment Risk

The value of our assets may be affected by prepayment rates on residential mortgage loans. We acquire RMBS and anticipate that the underlying residential mortgages loans will prepay at a projected rate generating an expected yield. If we purchase assets at a premium to par value, when borrowers prepay their residential mortgage loans faster than expected, the corresponding prepayments on the mortgage-related securities may reduce the expected yield on such securities because we will have to amortize the related premium on an accelerated basis, in the case of Agency RMBS whole pools and certain other investment grade rated securities, and make a retrospective adjustment to historical amortization. Conversely, if we purchase assets at a discount to par value, when borrowers prepay their residential mortgage loans slower than expected, the decrease in corresponding prepayments on the RMBS may reduce the expected yield on such securities because we will not be able to accrete the related discount as quickly as originally anticipated and, in the case of Agency RMBS whole pools and certain other investment grade rated securities, will have to make a retrospective adjustment to historical amortization.

Commercial mortgages frequently limit the ability of the borrower to prepay, thereby providing a certain level of prepayment protection. Common restrictions include yield maintenance and prepayment penalties, the proceeds of which are generally at least partially allocable to these securities, as well as defeasance.

Extension Risk

Most residential mortgage loans do not prohibit the partial or full prepayment of principal outstanding. Accordingly, while the stated maturity of a residential mortgage loan may be 30 years, or in some cases even longer, historically the vast majority of residential mortgage loans are satisfied prior to their maturity date. In periods of rising interest rates, borrowers have less incentive to refinance their existing mortgages and mortgage financing may not be as readily available. This generally results in a slower rate of prepayments and a corresponding longer weighted average life for MBS. The increase, or extension, in weighted average life is commonly referred to as Extension Risk which can negatively impact our portfolio. To the extent we receive smaller pre-payments of principal; we will have less to capital to invest in new securities. This is extremely detrimental in periods of rising interest rates as we will be unable to invest in new higher coupon MBS and a larger portion of our portfolio will remain invested in lower coupon securities. Further, our borrowing costs are generally short-term and, even if hedged, are likely to increase in a rising interest rate environment, thereby reducing our net interest margin. Finally, to the extent we acquired MBS at a discount to par, a portion of the overall return on these securities is based on the recovery of this discount. Slower principal prepayments will result in a longer recovery period and a lower overall return on our investment.

Counterparty Risk

The following discussion on counterparty risk reflects how these transactions are structured, rather than how they are presented for financial reporting purposes.

When we engage in repurchase transactions, we generally sell securities to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us, we could incur a loss on the transaction up to the amount of the haircut (assuming there was no change in the value of the securities).

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If a counterparty to a bi-lateral interest rate swap cannot perform under the terms of the interest rate swap, we may not receive payments due under that agreement, and thus, we may lose any unrealized gain associated with the interest rate swap. We may also risk the loss of any collateral we have pledged to secure our obligations under interest rate swap if the counterparty becomes insolvent or files for bankruptcy. In the case of a cleared swap, if our clearing broker were to default, become insolvent or file for bankruptcy, we may also risk the loss of any collateral we have posted to the clearing broker unless we were able to transfer or port our positions and held collateral to another clearing broker. In addition, the interest rate swap would no longer mitigate the impact of changes in interest rates as intended. As of September 2013, most of our interest swaps are cleared through a central clearing house which reduces but does not eliminate the aforementioned risks. Also see Liquidity Risk below.

Effective January 1, 2014, we have entered into master securities forward trading agreements, or MSFTAs, which would govern the trading of our TBA transactions. Pursuant to the terms of these MSFTAs, we and our counterparties would be required to post margin to the other when the mark to market exposure of the TBA transactions executed under the agreement exceed certain thresholds. On January 1, 2014, our Manager entered into MSFTAs with two counterparties and we expect to continue to negotiate and enter into MSFTAs with additional TBA counterparties. The margin provisions of the MSFTA help to mitigate, but do not eliminate, counterparty risk associated with TBA transactions. If a counterparty to a TBA transaction cannot perform under the terms of the trade, we may not receive securities we have agreed to purchase or payment for securities we have agreed to sell, and thus, we may lose any unrealized gain associated with such transaction.

Prior to entering into a trading agreement or transaction with any particular institution where we take on counterparty, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

Funding Risk

We have financed a substantial majority of our MBS with repurchase agreement financing. Over time, as market conditions change, in addition to these financings, we may use other forms of leverage. Weakness in the financial markets, the residential mortgage markets, the commercial mortgage markets and the economy generally could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing.

If a counterparty to one of the TBAs that we may enter into defaults on its obligations, we may not receive payments or securities due under the TBA agreement, and thus, we may lose any unrealized gain associated with that TBA transaction.

Liquidity Risk

Our liquidity risk is principally associated with the financing of long-maturity assets with short-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies, maturities are not required to be, nor are they, matched.

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by us, which may have a material adverse consequence on our business and results of operations.

In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or exist at possibly less advantageous terms. Further, if we are unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms, it may have a material adverse effect on our business, financial position, results of operations and cash flows, due to the long term nature of our investments and relatively short-term maturities of our repurchase agreements. As such, we cannot assure that we will always be able to roll over our repurchase agreements.

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The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate MBS will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could have a material adverse effect on our liquidity and results of operations.

In addition, the assets that comprise our asset portfolio are not traded on a public exchange. A portion of these assets may be subject to legal and other restrictions on resale or will otherwise be less liquid than publicly-traded securities. The illiquidity of our assets may make it difficult for us to sell such assets if the need or desire arises, including in response to changes in economic and other conditions.

We enter into swaps to manage our interest rate risk. We are required to pledge cash or securities as collateral as part of a margin arrangement, calculated daily, in connection with the swaps. The amount of margin that we are required to post will vary and generally reflects collateral posted with respect to swaps that are in an unrealized loss position to us and a percentage of the aggregate notional amount of swaps per counterparty. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call could result in a condition of default under our repurchase agreements, thereby resulting in liquidation of the collateral pledged by us, which may have a material adverse consequence on our business, financial position, results of operations and cash flows. Conversely, if our swaps are in an unrealized gain position, our counterparties to bilateral swaps are required to post collateral with us, under the same terms that we post collateral with them.

Inflation

Virtually all of our assets and liabilities are interest rate sensitive 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 directly correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our distributions will be determined by our board of directors consistent with our obligation to distribute to our stockholders at least 90% of our net taxable income on an annual basis, in accordance with the REIT regulations, in order to maintain our REIT qualification. In each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

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ITEM 4. Controls and Procedures

Our management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act) is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that the required information is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of March 31, 2014. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended March 31, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

From time to time, the Company may be involved in various claims and legal actions arising in the ordinary course of business. As of March 31, 2014, the Company was not involved in any legal proceedings.

ITEM 1A. Risk Factors

There were no material changes during the period covered by this report to the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2013, as filed with the SEC on March 17, 2014. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse effect on our business, financial condition and results of operation.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Mine Safety Disclosures

Not Applicable.

ITEM 5. Other Information

None.

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ITEM 6. Exhibits

(a) The following exhibits are filed as part of this report.

Exhibit No.	Description
3.1*	Amended and restated certificate of incorporation of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
3.2*	Amended and restated bylaws of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 3.2 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
4.1*	Specimen Common Stock Certificate of Western Asset Mortgage Capital Corporation, incorporated by reference to Exhibit 4.1 to Amendment No. 10 Form S-11 (Registration Statement No. 333-159962), filed May 8, 2012
10.1*	Form of Unit Purchase Agreement between Western Asset Mortgage Capital Corporation and certain institutional accredited investors, incorporated by reference to Exhibit 10.1 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.2*	Form of Warrant, incorporated by reference to Exhibit 10.2 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.3*	Management Agreement, dated May 9, 2012, between Western Asset Mortgage Capital Corporation and Western Asset Management Company, incorporated by reference to Exhibit 10.4 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.4*	Registration Rights Agreement, dated May 15, 2012, among Western Asset Mortgage Capital Corporation, Western Asset Management Company and certain individual holders named therein, incorporated by reference to Exhibit 10.5 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.5*	Western Asset Mortgage Capital Corporation Equity Plan, incorporated by reference to Exhibit 10.5 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.6*	Western Asset Mortgage Capital Corporation Manager Equity Plan, incorporated by reference to Exhibit 10.6 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.7*	Form of Indemnification Agreement between Western Asset Mortgage Capital Corporation and a director, incorporated by reference to Exhibit 10.7 to Amendment No. 9 Form S-11 (Registration Statement No. 333-159962), filed April 30, 2012.
10.8*	Restricted Stock Award Agreement, dated May 15, 2012, for Western Asset Management Company, incorporated by reference to Exhibit 10.9 to the Quarterly Report on Form 10-Q, filed August 14, 2012.
10.9*	Form of Restricted Stock Award Agreement for independent directors, incorporated by reference to Exhibit 10.2 to the Form S-8 dated May 15, 2012 (File No. 1-35543).
31.1	Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer

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

*Fully or partly previously filed.

**These interactive data files are furnished and not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act, and are not deemed filed for purposes of Section 18 of the Exchange Act, and otherwise are not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ GAVIN L. JAMES

Gavin L. James
President, Chief Executive Officer and Director (Principal Executive Officer)

May 12, 2014

By: /s/ STEVEN M. SHERWYN

Steven M. Sherwyn
Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

May 12, 2014