

Invesco Mortgage Capital Inc.  
Form 10-K  
February 29, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-K**

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2011

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Transition Period from            to

Commission file number 001-34385

**INVESCO MORTGAGE CAPITAL INC.**

(Exact name of registrant as specified in its charter)

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**Maryland**  
(State or other jurisdiction of  
incorporation or organization)  
**1555 Peachtree Street, N.E., Suite 1800**  
**Atlanta, Georgia**  
(Address of principal executive offices)

**26-2749336**  
(I.R.S. Employer  
Identification No.)

**30309**  
(Zip Code)

**(404) 892-0896**  
(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:**

| <b>Title of Each Class</b>   | <b>Name of Each Exchange on Which Registered</b> |
|--|--|
| <b>Common Stock, par value \$0.01 per share</b><br><b>Securities registered pursuant to Section 12(g) of the Securities Exchange Act of 1934: None</b> | <b>New York Stock Exchange</b>                   |

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

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

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

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

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

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

Large accelerated filer  Accelerated filer

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Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of the registrant's common stock held by non-affiliates was \$1,962,351,679 based on the closing sales price on the New York Stock Exchange on June 30, 2011

As of February 29, 2012, there were 115,399,742 outstanding shares of common stock of Invesco Mortgage Capital Inc.

## **Documents Incorporated by Reference**

Part III of this Form 10-K incorporates by reference certain information (solely to the extent explicitly indicated) from the registrant's proxy statement for the 2012 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A.

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**Forward-Looking Statements**

We make forward-looking statements in this Report and other filings we make with the SEC within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act ), and such statements are intended to be covered by the safe harbor provided by the same. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond our control. These forward-looking statements include information about possible or assumed future results of our business, financial condition, liquidity, results of operations, plans and objectives. When we use the words believe, expect, anticipate, estimate, plan, continue, intend, should, may or similar expressions and future or conditional will, may, could, should, and would, and any other statement that necessarily depends on future events, we intend to identify forward-looking statements. Factors that could cause actual results to differ from those expressed in our forward-looking statements include, but are not limited to:

the impact of any deficiencies in foreclosure practices of third parties and related delays in the foreclosure process;

our business and investment strategy;

our investment portfolio;

our projected operating results;

actions and initiatives of the U.S. government and changes to U.S. government policies, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act ) and our ability to respond to and comply with such actions, initiatives and changes;

our ability to obtain additional financing arrangements and the terms of such arrangements;

financing and advance rates for our target assets;

changes to our expected leverage;

general volatility of the securities markets in which we invest;

general volatility of foreign financial markets and their governments' responses;

interest rate mismatches between our target assets and our borrowings used to fund such investments;

the adequacy of our cash flow from operations and borrowings to meet our short-term liquidity needs;

our ability to maintain sufficient liquidity to meet any margin calls;

changes in the credit rating of the U.S. government;

changes in interest rates and the market value of our target assets;

changes in prepayment rates on our target assets;

effects of hedging instruments on our target assets;

rates of default or decreased recovery rates on our target assets;

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modifications to whole loans or loans underlying securities;

the degree to which our hedging strategies may or may not protect us from interest rate volatility;

changes in governmental regulations, tax law and rates, and similar matters and our ability to respond to such changes;

our ability to qualify as a REIT for U.S. federal income tax purposes;

our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended (the "1940 Act");

availability of investment opportunities in mortgage-related, real estate-related and other securities;

availability of U.S. government Agency guarantees with regard to payments of principal and interest on securities;

availability of qualified personnel;

our understanding of our competition;

changes to accounting principles generally accepted in the United States of America ("US GAAP"); and

market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

These forward-looking statements are based upon information presently available to our management and are inherently subjective, uncertain and subject to change. There can be no assurance that actual results will not differ materially from our expectations. We caution investors not to rely unduly on any forward-looking statements and urge you to carefully consider the risks identified under the captions "Risk Factors,"

"Forward-Looking Statements" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this Annual Report on Form 10-K.

All written or oral forward-looking statements that we make, or that are attributable to us, are expressly qualified by this cautionary notice. We expressly disclaim any obligation to update the information in any public disclosure if any forward-looking statement later turns out to be inaccurate, except as may otherwise be required by law.

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**PART I**

**Item 1. Business.**

**Our Company**

We are a Maryland Corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans, which we collectively refer to as our target assets. Our objective is to provide risk-adjusted returns to our investors, primarily through dividends and secondarily through capital appreciation. To achieve this objective, we selectively acquire our target assets to construct a diversified investment portfolio designed to produce returns across a variety of market conditions and economic cycles.

Our target assets consist of residential mortgage-backed securities ( RMBS ) for which a U.S. government agency such as the Government National Mortgage Association ( Ginnie Mae ) or a federally chartered corporation such as the Federal National Mortgage Association ( Fannie Mae ) or the Federal Home Loan Mortgage Corporation ( Freddie Mac ) guarantees payments of principal and interest on the securities. We refer to these securities as Agency RMBS. Our Agency RMBS investments include mortgage pass-through securities and may include collateralized mortgage obligations ( CMOs ). We also invest in RMBS that are not issued or guaranteed by a U.S. government agency ( non-Agency RMBS ), commercial mortgage-backed securities ( CMBS ) and residential and commercial mortgage loans.

The Company finances its Agency RMBS, non-Agency RMBS and CMBS investments through short-term borrowings structured as repurchase agreements. Our manager, Invesco Advisors Inc. (our Manager ) has secured commitments for the Company with a number of repurchase agreement counterparties. The Company also finances its investments in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing capital to the Invesco Mortgage Recovery Feeder Fund ( Invesco IMRF Fund ) that invests in public-private investment funds ( PPIF ) managed by the Company's Manager as part of the Public-Private Investment Program ( PPIP ) created by the U.S. Treasury in conjunction with the Federal Deposit Insurance Corporation (the FDIC ) and the Federal Reserve. See Our Manager . In addition, the Company may use other sources of financing including committed borrowing facilities and other private financing.

We are a real estate investment trust ( REIT ) for U.S. federal income tax purposes. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to our shareholders and maintain our qualification as a REIT. We operate our business in a manner that permits us to maintain our exemption from registration under the 1940 Act.

**Public Offerings**

On March 25, 2011, the Company completed a follow-on common stock offering of 19,000,000 shares of common stock and an issuance of an additional 2,850,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.07 per share. Net proceeds to the Company were \$460.1 million, net of issuance costs of approximately \$317,000.

On June 23, 2011, the Company completed a follow-on common stock offering of 17,000,000 shares of common stock and an issuance of an additional 2,550,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$20.15 per share. Net proceeds to the Company were \$388.8 million, net of issuance costs of approximately \$5.1 million.

On August 23, 2011, the Company completed a follow-on common stock offering of 20,000,000 shares of common stock at \$18.37 per share. Net proceeds to the Company were \$362.3 million, net of issuance costs of approximately \$5.1 million.

During the year ended December 31, 2011, the Company issued 4,121,638 shares of common stock at an average price of \$20.93 under the share repurchase feature of the Company's Dividend Reinvestment and Share Purchase Plan ( DRSP ) with total proceeds to the Company of approximately \$85.8 million, net of issuance costs.



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**Our Manager**

We are externally managed and advised by our Manager, an SEC-registered investment adviser and indirect, wholly-owned subsidiary of Invesco Ltd. (NYSE: IVZ) ( Invesco ).

Pursuant to the terms of the management agreement, our Manager provides us with our management team, including our officers, along with appropriate support personnel. Each of our officers is an employee of Invesco. We do not have any employees. With the exception of our Chief Financial Officer and our Controller, our Manager and its affiliates do not dedicate any of their respective employees exclusively to us, nor is our Manager and its affiliates or their respective employees obligated to dedicate any specific portion of its or their time to our business. Our Manager is at all times subject to the supervision and oversight of our board of directors and has only such functions and authority as our board of directors delegates to it.

**Our Competitive Advantages**

We believe that our competitive advantages include the following:

***Significant Experience of Our Manager***

Our Manager's senior management team has a long track record and broad experience in managing residential and commercial mortgage-related assets through a variety of credit and interest rate environments and has demonstrated the ability to generate attractive risk-adjusted returns under different market conditions and cycles. In addition, our Manager benefits from the insight and capabilities of WL Ross & Co. LLC ( WL Ross ) and Invesco's real estate team. Through WL Ross and Invesco's real estate team, we have access to broad and deep teams of experienced investment professionals in real estate and distressed investing. Through these teams, we have real time access to research and data on the mortgage and real estate industries. We believe having in-house access to these resources and expertise provides us with a competitive advantage over other companies investing in our target assets who have less internal resources and expertise.

***Extensive Strategic Relationships and Experience of our Manager and its Affiliates***

Our Manager maintains extensive long-term relationships with other financial intermediaries, including primary dealers, leading investment banks, brokerage firms, leading mortgage originators and commercial banks. We believe these relationships enhance our ability to source, finance and hedge investment opportunities and, thus, will enable us to grow in various credit and interest rate environments.

***Disciplined Investment Approach***

We seek to maximize our risk-adjusted returns through our Manager's disciplined investment approach, which relies on rigorous quantitative and qualitative analysis. Our Manager monitors our overall portfolio risk and evaluates the characteristics of our investments in our target assets including, but not limited to, loan balance distribution, geographic concentration, property type, occupancy, periodic interest rate caps (which limit the amount an interest rate can increase during any given period), lifetime interest rate caps, weighted-average loan-to-value and weighted-average credit score. In addition, with respect to any particular target asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates recovery of various sectors and vintage of collateral. We believe this strategy and our commitment to capital preservation provide us with a competitive advantage when operating in a variety of market conditions.

***Access to Our Manager's Sophisticated Analytical Tools, Infrastructure and Expertise***

We utilize our Manager's proprietary and third-party mortgage-related security and portfolio management tools to generate an attractive, risk-adjusted net interest margin from our portfolio. We focus on in-depth analysis of the numerous factors that influence our target assets, including: (1) fundamental market and sector review; (2) rigorous cash flow analysis; (3) disciplined security selection; (4) controlled risk exposure; and (5) prudent

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balance sheet management. We utilize these tools to guide the hedging strategies developed by our Manager to the extent consistent with satisfying the requirements for qualification as a REIT. In addition, we use our Manager's proprietary technology management platform called QTech<sup>sm</sup> to monitor investment risk. QTech<sup>sm</sup> collects and stores real-time market data and integrates markets performance with portfolio holdings and proprietary risk models to measure portfolio risk positions. This measurement system portrays overall portfolio risk and its sources. Through the use of these tools, we analyze factors that affect the rate at which mortgage prepayments occur, including changes in the level of interest rates, directional trends in residential and commercial real estate prices, general economic conditions, the locations of the properties securing the mortgage loans and other social and demographic conditions in order to acquire our target assets.

Our Manager has created and maintains analytical and portfolio management capabilities to aid in security selection and risk management. We capitalize on the market knowledge and ready access to data across our target markets that our Manager and its affiliates obtain through their established platform. We also benefit from our Manager's and its affiliates' comprehensive financial and administrative infrastructure, including its risk management and financial reporting operations, as well as its business development, legal and compliance teams.

### **Investment Strategy**

We invest in a diversified pool of mortgage assets that generate attractive risk adjusted returns. Our target assets include Agency RMBS, non-Agency RMBS, CMBS and residential and commercial mortgage loans. In addition to direct purchases of our target assets, we also invest in equity investments such as the Invesco IMRF Fund, which, in turn, invests in our target assets. Our Manager's investment committee makes investment decisions for the Invesco IMRF Fund.

#### ***Agency RMBS***

Agency RMBS are residential mortgage-backed securities for which a U.S. government agency such as Ginnie Mae, or a federally chartered corporation such as Fannie Mae or Freddie Mac guarantees payments of principal and interest on the securities. Payments of principal and interest on Agency RMBS, not the market value of the securities themselves, are guaranteed. Agency RMBS differ from other forms of traditional debt securities, which normally provide for periodic payments of interest in fixed amounts with principal payments at maturity or on specified call dates. Instead, Agency RMBS provide for monthly payments, which consist of both principal and interest. In effect, these payments are a pass-through of scheduled and prepaid principal payments and the monthly interest payments made by the individual borrowers on the mortgage loans, net of any fees paid to the servicers, guarantors or other related parties of the securities.

The principal may be prepaid at any time due to prepayments on the underlying mortgage loans or other assets. These differences can result in significantly greater price and yield volatility than is the case with other fixed-income securities.

Various factors affect the rate at which mortgage prepayments occur, including changes in the level and directional trends in housing prices, interest rates, general economic conditions, the age of the mortgage loan, the location of the property, other social and demographic conditions, government initiated refinance programs, legislative regulations, and industry capacity. Generally, prepayments on Agency RMBS increase during periods of falling mortgage interest rates and decrease during periods of rising mortgage interest rates. However, this may not always be the case. We may reinvest principal repayments at a yield that is higher or lower than the yield on the repaid investment, thus affecting our net interest income by altering the average yield on our assets.

However, when interest rates are declining, the value of Agency RMBS with prepayment options may not increase as much as other fixed income securities. The rate of prepayments on underlying mortgages will affect the price and volatility of Agency RMBS and may have the effect of shortening or extending the duration of the security beyond what was anticipated at the time of purchase. When interest rates rise, our holdings of Agency RMBS may experience reduced returns if the owners of the underlying mortgages pay off their mortgages slower than anticipated. This is generally referred to as extension risk.

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Mortgage pass-through certificates, CMOs, Freddie Mac Gold Certificates, Fannie Mae Certificates and Ginnie Mae Certificates are types of Agency RMBS that are collateralized by either fixed-rate mortgage loans ( FRMs ), adjustable-rate mortgage loans ( ARMs ), or hybrid ARMs. FRMs have an interest rate that is fixed for the term of the loan and do not adjust. The interest rates on ARMs generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid ARMs 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. ARMs and hybrid ARMs generally have periodic and lifetime constraints on how much the loan interest rate can change on any predetermined interest rate reset date. Our allocation of our Agency RMBS collateralized by FRMs, ARMs or hybrid ARMs will depend on various factors including, but not limited to, relative value, expected future prepayment trends, supply and demand, costs of hedging, costs of financing, expected future interest rate volatility and the overall shape of the U.S. Treasury and interest rate swap yield curves. We take these factors into account when we make investments.

#### ***Non-Agency RMBS***

Non-Agency RMBS are residential mortgage-backed securities that are not issued or guaranteed by a U.S. government agency. Like Agency RMBS, non-Agency RMBS represent interests in pools of mortgage loans secured by residential real property. The mortgage loan collateral for non-Agency RMBS generally consists of residential mortgage loans that do not generally conform to the U.S. government agency underwriting guidelines due to certain factors including mortgage balance in excess of such guidelines, borrower characteristics, loan characteristics and level of documentation.

#### ***CMBS***

CMBS are securities backed by obligations (including certificates of participation in obligations) that are principally secured by commercial mortgages on real property or interests therein having a multifamily or commercial use, such as regional malls, other retail space, office buildings, industrial or warehouse properties, hotels, apartments, nursing homes and senior living facilities.

CMBS are typically issued in multiple tranches whereby the more senior classes are entitled to priority distributions to make specified interest and principal payments on such tranches. Losses and other shortfalls from expected amounts to be received on the mortgage pool are borne by the most subordinate classes, which receive payments only after the more senior classes have received all principal and/or interest to which they are entitled. The credit quality of CMBS depends on the credit quality of the underlying mortgage loans, which is a function of factors such as the following: the principal amount of loans relative to the value of the related properties; the mortgage loan terms, such as amortization; market assessment and geographic location; construction quality of the property; and the creditworthiness of the borrowers.

#### ***Residential Mortgage Loans***

Residential mortgage loans are loans secured by residential real properties. We generally focus our residential mortgage loan acquisitions on the purchase of loan portfolios that are first lien, single-family FRMs, ARMs and Hybrid ARMs with original terms to maturity of not more than 40 years and that are either fully amortizing or are interest-only for up to ten years, and fully amortizing thereafter.

#### ***Prime and Jumbo Prime Mortgage Loans***

Prime mortgage loans are mortgage loans that generally require borrower credit histories, debt-to-income ratios and loan-to-value ratios similar to those dictated by U.S. government agency underwriting guidelines, though in certain cases they may not meet the same income documentation or other requirements. Jumbo prime mortgage loans are mortgage loans with requirements similar to prime mortgage loans except that the mortgage balance exceeds the maximum amount permitted by U.S. government agency underwriting guidelines.

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#### *Alt-A Mortgage Loans*

Alt-A mortgage loans are mortgage loans made to borrowers whose qualifying mortgage characteristics do not conform to U.S. government agency underwriting guidelines, but whose borrower characteristics may. Generally, Alt-A mortgage loans allow homeowners to qualify for a mortgage loan with reduced or alternative forms of documentation. The credit quality of Alt-A borrowers generally exceeds the credit quality of subprime borrowers.

#### *Subprime Mortgage Loans*

Subprime mortgage loans are loans that do not conform to U.S. government agency underwriting guidelines. Subprime borrowers generally have imperfect or impaired credit histories and/or low credit scores.

#### *Re-securitization of a Real Estate Mortgage Investment Conduit*

A re-securitization of a real estate mortgage investment conduit ( Re-REMIC ) is a transaction in which an existing security or securities is transferred to a special purpose entity that has formed a securitization vehicle that will issue multiple classes of securities secured by and payable from cash flows on the underlying securities.

#### *Commercial Mortgage Loans*

Commercial mortgage loans are mortgage loans secured by first or second liens on commercial properties such as regional malls, retail space, office buildings, industrial or warehouse properties, hotels, apartments, nursing homes and senior living facilities. These loans, which tend to range in term from five to 15 years, can carry either fixed or floating interest rates. They generally permit pre-payments before final maturity but may require the payment to the lender of yield maintenance pre-payment penalties. First lien loans represent the senior lien on a property while second lien loans or second mortgages represent a subordinate or second lien on a property.

#### *B-Notes*

A B-Note, unlike a second mortgage loan, is part of a single larger commercial mortgage loan, with the other part evidenced by an A-Note. The holders of the A-Note and B-Note enter into an agreement which sets forth the respective rights and obligations of each of the holders. The terms of the agreement provide that the holder of the A-Note has a priority of payment over the holder of the B-Note. A loan evidenced by a note which is secured by a second mortgage is a separate loan and the holder has a direct relationship with the borrower. In addition, unlike the holder of a B-Note, the holder of the loan would also be the holder of the mortgage. The holder of the second mortgage loan typically enters into an intercreditor agreement with the holder of the first mortgage loan which sets forth the respective rights and obligations of each of the holders, similar in substance to the agreement that is entered into between the holder of the A-Note and the holder of the B-Note. B-Note lenders have the same obligations, collateral and borrower as the A-Note lender, but typically are subordinated in recovery upon a default.

#### *Bridge Loans*

Bridge loans tend to be floating rate whole loans made to borrowers who are seeking short-term capital (with terms of up to five years) to be used in the acquisition, construction or redevelopment of a property. This type of bridge financing enables the borrower to secure short-term financing while improving the property and to avoid burdening it with restrictive long-term debt.

#### *Mezzanine Loans*

Mezzanine loans are generally structured to represent a senior position in the borrower's equity in, and subordinate to a first mortgage loan on, a property. These loans are generally secured by pledges of ownership interests, in whole or in part, in entities that directly or indirectly own the real property. At times, mezzanine loans may be secured by additional collateral, including letters of credit, personal guarantees, or collateral unrelated to the property. Mezzanine loans may be structured to carry either fixed or floating interest rates as well as carry a right to participate in a percentage of gross revenues and a percentage of the increase in the fair market value of the property securing the loan. Mezzanine loans may also contain prepayment lockouts, penalties, minimum profit hurdles and other mechanisms to protect and enhance returns to the lender. Mezzanine loans usually have maturities that match the maturity of the related mortgage loan but may have shorter or longer terms.



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#### ***Equity Investments***

The Company has investments in unconsolidated ventures. In circumstances where the Company has a non-controlling interest but is deemed to be able to exert significant influence over the affairs of the enterprise, the Company utilizes the equity method of accounting. Under the equity method of accounting, the initial investment is increased each period for additional capital contributions and a proportionate share of the entity's earnings and decreased for cash distributions and a proportionate share of the entity's losses.

#### ***Financing Strategy***

We finance our investments in Agency RMBS, non-Agency RMBS and CMBS, primarily through short-term borrowings structured as repurchase agreements, committed facilities and other forms of private financing. In addition, we historically financed our investments in CMBS with financing under the U.S. Government's Term Asset-Backed Securities Loan Facility ( TALF ) which was repaid in 2010 and replaced with repurchase agreements. We also finance our investments in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by investing in the Invesco IMRF Fund, which received financing from the U.S. Treasury and from the FDIC.

#### ***Repurchase Agreements***

Repurchase agreements are financings pursuant to which we sell our target assets to the repurchase agreement counterparty, the buyer, for an agreed upon price with the obligation to repurchase these assets from the buyer at a future date and at a price higher than the original purchase price. The amount of financing we receive under a repurchase agreement is limited to a specified percentage of the estimated market value of the assets we sell to the buyer. The difference between the sale price and repurchase price is the cost, or interest expense, of financing under a repurchase agreement. Under repurchase agreement financing arrangements, certain buyers require us to provide additional cash collateral, referred to as margin call, to re-establish the ratio of value of the collateral to the amount of borrowing.

#### ***Leverage***

We use leverage on our target assets to achieve our return objectives. We generally target a total debt-to-equity ratio of approximately 3 to 7 times. Our leverage ratio may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense, while maintaining our overall portfolio leverage guidelines.

#### ***Risk Management Strategy***

##### ***Market Risk Management***

Risk management is an integral component of our strategy to deliver returns to our shareholders. Because we invest in mortgage-backed securities ( MBS ), investment losses from prepayment, interest rate volatility or other risks can meaningfully impact our earnings and our distributions to shareholders. In addition, because we employ financial leverage in funding our investment portfolio, mismatches in the maturities of our assets and liabilities can create the need to continually renew or otherwise refinance our liabilities. Our results are dependent upon a positive spread between the returns on our asset portfolio and our overall cost of funding. To minimize the risks to our portfolio, we actively employ portfolio-wide and security-specific risk measurement and management processes in our daily operations. Our Manager's risk management tools include software and services licensed or purchased from third parties, in addition to proprietary software and analytical methods developed by Invesco.

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#### *Interest Rate Hedging*

Subject to maintaining our qualification as a REIT, we engage in a variety of interest rate management techniques that seek to mitigate the influence of interest rate changes on the costs of liabilities and help us achieve our risk management objective. Specifically, we seek to hedge our exposure to potential interest rate mismatches between the interest we earn on our investments and our borrowing costs caused by fluctuations in short-term interest rates. In utilizing leverage and interest rate hedges, we seek to improve risk-adjusted returns and, where possible, to lock in, on a long-term basis, a favorable spread between the yield on our assets and the cost of our financing. We may utilize various derivative financial instruments, including, puts and calls on securities or indices of securities, interest rate swaps, interest rate caps, exchange-traded derivatives, U.S. Treasury securities and options on U.S. Treasury securities and interest rate floors to hedge all or a portion of the interest rate risk associated with the financing of our investment portfolio.

#### *Credit Risk*

We believe our investment strategy generally keeps our credit losses and financing costs low. However, we retain the risk of potential credit losses on all of the residential and commercial mortgage loans, as well as the loans underlying the non-Agency RMBS and CMBS we hold. We seek to manage this risk through our pre-acquisition due diligence process and continuous re-evaluation of the portfolio. In addition, with respect to any particular target asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral.

### **Investment Guidelines**

Our board of directors has adopted the following investment guidelines:

no investment shall be made that would cause us to fail to qualify as a REIT for federal income tax purposes;

no investment shall be made that would cause us to be regulated as an investment company under the 1940 Act;

our assets will be invested within our target assets; and

until appropriate investments can be identified, our Manager may pay off short-term debt or invest the proceeds of any offering in interest-bearing, short-term investments, including funds that are consistent with maintaining our REIT qualification.

These investment guidelines may be changed from time to time by our board of directors without the approval of our shareholders.

### **Investment Committee**

We maintain our investment committee which is comprised of certain of our officers and certain of our Manager's investment professionals. The investment committee periodically reviews our investment portfolio and its compliance with our investment policies and procedures, including our investment guidelines, and our Manager provides our board of directors an investment report at the end of each quarter in conjunction with its review of our quarterly results. In addition, our Manager has a separate investment committee that makes investment decisions for the Invesco IMRF Fund.

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**Investment Process**

Our Manager's investment team has a strong focus on security selection and on the relative value of various sectors within the mortgage market. Our Manager utilizes this expertise to build a diversified portfolio. Our Manager incorporates its views on the economic environment and the outlook for the mortgage market, including relative valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, housing prices, delinquencies, default rates, recovery of various sectors and vintage of collateral.

Our investment process includes sourcing and screening investment opportunities, assessing investment suitability, conducting interest rate and prepayment analysis, evaluating cash flow and collateral performance, reviewing legal structure and servicer and originator information and investment structuring, as appropriate, to ensure an attractive return commensurate with the risk we are bearing. Upon identification of an investment opportunity, the investment will be screened and monitored by our Manager to determine its impact on maintaining our REIT qualification and our exemption from registration under the 1940 Act. We make investments in sectors where our Manager has strong core competencies and where we believe market risk and expected performance can be reasonably quantified.

Our Manager evaluates each of our investment opportunities based on its expected risk-adjusted return relative to the returns available from other, comparable investments. In addition, we evaluate new opportunities based on their relative expected returns compared to securities held in our portfolio. The terms of any leverage available to us for use in funding an investment purchase are also taken into consideration, as are any risks posed by illiquidity or correlations with other securities in the portfolio. Our Manager also develops a macro outlook with respect to each target asset class by examining factors in the broader economy such as gross domestic product, interest rates, unemployment rates and availability of credit, among other factors. Our Manager analyzes fundamental trends in the relevant target asset class sector to adjust or maintain its outlook for that particular target asset class. Views on a particular target asset class are recorded in our Manager's QTec® system. These macro decisions guide our Manager's assumptions regarding model inputs and portfolio allocations among target assets. Additionally, our Manager conducts extensive diligence with respect to each target asset class by, among other things, examining and monitoring the capabilities and financial wherewithal of the parties responsible for the origination, administration and servicing of relevant target assets.

**Competition**

Our net income depends, in large part, on our ability to acquire assets at favorable spreads over our borrowing costs. In acquiring our investments, we compete with other REITs, specialty finance companies, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, financial institutions, governmental bodies and other entities. See Management's Discussion and Analysis of Financial Condition and Results of Operations – Market Conditions. In addition, there are numerous REITs with similar asset acquisition objectives. These other REITs increase competition for the available supply of mortgage assets suitable for purchase. Many of our competitors are significantly larger than we are, have access to greater capital and other resources and may have other advantages over us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships than we can. Current market conditions may attract more competitors, which may increase the competition for sources of financing. An increase in the competition for sources of financing could adversely affect the availability and cost of financing.

We have access to our Manager's professionals and their industry expertise, which we believe provides us with a competitive advantage. These professionals help us assess investment risks and determine appropriate pricing for certain potential investments. These relationships enable us to compete more effectively for attractive investment opportunities. Despite certain competitive advantages, we may not be able to achieve our business goals or expectations due to the competitive risks that we face. For additional information concerning these competitive risks, see Risk Factors – Risks Related to Our Investments. We operate in a highly competitive market for investment opportunities and competition may limit our ability to acquire desirable investments in our target assets and could also affect the pricing of these securities.



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**Staffing**

We are managed by our Manager pursuant to the management agreement between our Manager and us. See **Certain Relationships, Related Transactions, and Director Independence** for a discussion of the management fee and our relationship with our Manager. All of our officers are employees of Invesco. We do not have any employees.

**Our Corporate Information**

Our principal executive offices are located at 1555 Peachtree Street, N.E., Atlanta, Georgia 30309. Our telephone number is (404) 892-0896. Our website is [www.invescomortgagecapital.com](http://www.invescomortgagecapital.com). We make available free of charge, through our corporate website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. The contents of our website are not a part of this Report. The information on our website is not intended to form a part of or be incorporated by reference into this Report.

**Item 1A. Risk Factors.**

*Investing in our common stock involves a high degree of risk. If any of the following risks occur, our business, financial condition or results of operations could be materially and adversely affected. In that case, the trading price of our common stock could decline and you may lose some or all of your investment.*

**Risks Related to Our Relationship with Our Manager**

*We are dependent on our Manager and its key personnel for our success.*

We have no separate facilities and are completely reliant on our Manager. We do not have any employees. Our executive officers are employees of Invesco. Our Manager has significant discretion as to the implementation of our investment and operating policies and strategies. Accordingly, we believe that our success depends to a significant extent upon the efforts, experience, diligence, skill and network of business contacts of the executive officers and key personnel of our Manager. The executive officers and key personnel of our Manager evaluate, negotiate, close and monitor our investments; therefore, our success depends on their continued service. The departure of any of the executive officers or key personnel of our Manager could have a material adverse effect on our performance. In addition, we offer no assurance that our Manager will remain our investment manager or that we will continue to have access to our Manager's principals and professionals. The initial term of our management agreement with our Manager expired on the second anniversary of the closing of our initial public offering ( IPO ), or July 1, 2011. The agreement automatically renews for successive one-year terms, and the management agreement is currently in a renewal term. If the management agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan. Moreover, with the exception of our Chief Financial Officer and our Controller, our Manager is not obligated to dedicate certain of its personnel exclusively to us nor is it obligated to dedicate any specific portion of its time to our business.

Our Manager has obtained commitments on our behalf from a number of the counterparties. Therefore, if the management agreement is terminated, we have no assurance that we would continue to have access to these sources of financing for our investments.

*There are conflicts of interest in our relationship with our Manager and Invesco, which could result in decisions that are not in the best interests of our shareholders.*

We are subject to conflicts of interest arising out of our relationship with Invesco and our Manager. Specifically, each of our officers and two of our directors, Mr. Armour and Ms. Dunn Kelley, are employees of Invesco. Our Manager and our executive officers may have conflicts between their duties to us and their duties to, and interests in, Invesco. We compete for investment opportunities directly with other clients of our Manager or Invesco and its subsidiaries. A substantial number of separate accounts managed by our Manager have limited

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exposure to our target assets. In addition, in the future our Manager may have additional clients that compete directly with us for investment opportunities. Our Manager has an investment and financing allocation policy in place intended to enable us to share equitably with the other clients of our Manager or Invesco and its subsidiaries. Therefore, we may compete for investment or financing opportunities sourced by our Manager and, as a result, we may either not be presented with the opportunity or have to compete with other clients of our Manager or clients of Invesco and its subsidiaries to acquire these investments or have access to these sources of financing. Our Manager and our executive officers may choose to allocate favorable investments to other clients of Invesco instead of to us. Further, when there are turbulent conditions in the mortgage markets, distress in the credit markets or other times when we will need focused support and assistance from our Manager, Invesco or entities for which our Manager also acts as an investment manager will likewise require greater focus and attention, placing our Manager's resources in high demand. In such situations, we may not receive the level of support and assistance that we may receive if we were internally managed or if our Manager did not act as a manager for other entities. There is no assurance that our Manager's allocation policies that address some of the conflicts relating to our access to investment and financing sources will be adequate to address all of the conflicts that may arise.

We pay our Manager substantial management fees regardless of the performance of our portfolio. Our Manager's entitlement to a management fee, which is not based upon performance metrics or goals, might reduce its incentive to devote its time and effort to seeking investments that provide attractive risk-adjusted returns for our portfolio. This in turn could hurt both our ability to make distributions to our shareholders and the market price of our common stock.

Concurrent with the completion of our IPO, we completed a private placement in which we sold 75,000 shares of our common stock to our Manager and 1,425,000 Operating Partnership ( OP ) units to Invesco Investments (Bermuda) Ltd., a wholly-owned subsidiary of Invesco. Each of our Manager and Invesco Investments (Bermuda) Ltd. may sell any of these securities at any time. To the extent our Manager or Invesco Investments (Bermuda) Ltd. sell some of these securities, its interests may be less aligned with our interests.

***Our Manager would have a conflict in recommending our participation in any equity investment it manages.***

Our Manager has a conflict of interest in recommending our participation in any equity investment it manages because the fees payable to it may be greater than the fees payable by us under the management agreement. With respect to certain equity investments we have made, our Manager has agreed to waive fees at the equity investment level to avoid duplication. To address any potential conflict of interest, we require the terms of any equity investment managed by our Manager to be approved by our audit committee consisting of our independent directors. However, there can be no assurance that all conflicts of interest will be eliminated.

***The management agreement with our Manager was not negotiated on an arm's-length basis and may not be as favorable to us as if it had been negotiated with an unaffiliated third party and may be costly and difficult to terminate.***

Our executive officers and two of our five directors are employees of Invesco. Our management agreement with our Manager was negotiated between related parties and its terms, including fees payable, may not be as favorable to us as if it had been negotiated with an unaffiliated third party.

Termination of the management agreement with our Manager without cause is difficult and costly. Our independent directors will review our Manager's performance and the management fees annually and, following the initial two-year term, the management agreement may be terminated annually upon the affirmative vote of at least two-thirds of our independent directors based upon: (1) our Manager's unsatisfactory performance that is materially detrimental to us, or (2) a determination that the management fees payable to our Manager are not fair, subject to our Manager's right to prevent termination based on unfair fees by accepting a reduction of management fees agreed to by at least two-thirds of our independent directors. Our Manager will be provided 180 days prior notice of any such termination. Additionally, upon such a termination, the management agreement provides that we will pay our Manager a termination fee equal to three times the sum of the average annual management fee received by our Manager during the prior 24-month period before such termination, calculated as of the end of the most recently completed fiscal quarter. These provisions may increase the cost of terminating the management agreement and adversely affect our ability to terminate our Manager without cause.

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The initial term of our management agreement expired July 1, 2011. The agreement automatically renews for successive one-year terms, and the management is currently in a renewal term. Our Manager may terminate the management agreement annually upon 180 days prior notice. If the management agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan.

Pursuant to the management agreement, our Manager does not assume any responsibility other than to render the services called for thereunder and is not responsible for any action of our board of directors in following or declining to follow its advice or recommendations. Our Manager maintains a contractual, as opposed to a fiduciary, relationship with us. Under the terms of the management agreement, our Manager, its officers, shareholders, members, managers, partners, directors and personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager will not be liable to us, any subsidiary of ours, our directors, our shareholders or any subsidiary shareholders or partners for acts or omissions performed in accordance with and pursuant to the management agreement, except because of acts constituting bad faith, willful misconduct, gross negligence, or reckless disregard of their duties under the management agreement, as determined by a final non-appealable order of a court of competent jurisdiction. We have agreed to indemnify our Manager, its officers, shareholders, members, managers, directors and personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of our Manager not constituting bad faith, willful misconduct, gross negligence, or reckless disregard of duties, performed in good faith in accordance with and pursuant to the management agreement.

***Our board of directors approved very broad investment guidelines for our Manager and does not approve each investment and financing decision made by our Manager.***

Our Manager is authorized to follow very broad investment guidelines. Our board of directors will periodically review our investment guidelines and our investment portfolio but does not, and is not required to, review all of our proposed investments, except that an investment in a security structured or issued by an entity managed by Invesco must be approved by a majority of our independent directors prior to such investment. In addition, in conducting periodic reviews, our board of directors may rely primarily on information provided to them by our Manager. Furthermore, our Manager may use complex strategies, and transactions entered into by our Manager may be costly, difficult or impossible to unwind by the time they are reviewed by our board of directors. Our Manager has great latitude within the broad parameters of our investment guidelines in determining the types and amounts of Agency RMBS, non-Agency RMBS, CMBS and mortgage loans it may decide are attractive investments for us, which could result in investment returns that are substantially below expectations or that result in losses, which would materially and adversely affect our business operations and results.

**Risks Related to Our Company**

***Maintenance of our 1940 Act exemption imposes limits on our operations; Failure to maintain an exemption could have a material negative impact on our operations.***

We conduct our operations so that neither we, nor our operating partnership, IAS Operating Partnership LP (the Operating Partnership) nor the subsidiaries of the Operating Partnership are required to register as an investment company under the 1940 Act.

Section 3(a)(1)(A) of the 1940 Act defines an investment company as any issuer that is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities. Section 3(a)(1)(C) of the 1940 Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. Excluded from the term investment securities, among other things, are U.S. government securities and securities issued by majority-owned subsidiaries that are not themselves investment companies and are not relying on the exception from the definition of investment company set forth in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

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We are a holding company that conducts its businesses through the Operating Partnership and the Operating Partnership's wholly-owned or majority-owned subsidiaries. Both we and the Operating Partnership conduct our operations so that we comply with the 40% test. Accordingly, the securities issued by these subsidiaries that are excepted from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the Operating Partnership may own, may not have a combined value in excess of 40% of the value of the Operating Partnership's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. This requirement limits the types of businesses in which we are permitted to engage in through our subsidiaries. Similarly, IAS Asset I LLC and certain of the Operating Partnership's other subsidiaries that we may form in the future intend to rely upon the exemption from registration as an investment company under the 1940 Act pursuant to Section 3(c)(5)(C) of the 1940 Act, which is available for entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. This exemption generally requires that at least 55% of a subsidiary's portfolio must be comprised of qualifying assets and at least 80% of its portfolio must be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose include mortgage loans and other assets, such as whole pool Agency and non-Agency RMBS, that the SEC staff in various no-action letters has determined are the functional equivalent of mortgage loans for the purposes of the 1940 Act. We treat as real estate-related assets CMBS, debt and equity securities of companies primarily engaged in real estate businesses, agency partial pool certificates and securities issued by pass-through entities of which substantially all of the assets consist of qualifying assets and/or real estate-related assets. IAS Asset I LLC invests in the Invesco IMRF Fund. We treat IAS Asset I LLC's investment in the Invesco IMRF Fund as a real estate-related asset for purposes of the Section 3(c)(5)(C) analysis. As a result, IAS Asset I LLC can invest no more than 45% of its assets in the Invesco IMRF Fund and other real estate-related assets. We note that the SEC has not provided any guidance on the treatment of interests in PPIFs as real estate-related assets and any such guidance may require us to change our strategy. We may need to adjust IAS Asset I LLC's assets and strategy in order for it to continue to rely on Section 3(c)(5)(C) for its 1940 Act exemption. Any such adjustment in IAS Asset I LLC's assets or strategy is not expected to have a material adverse effect on our business or strategy. Although we monitor our portfolio periodically and prior to each investment acquisition, there can be no assurance that we will be able to maintain this exemption from registration for IAS Asset I LLC and such other subsidiaries that we may form in the future intending to rely on Section 3(c)(5)(C) of the 40 Act. The legacy securities PPIF formed and managed by our Manager or one of its affiliates relies on Section 3(c)(7) for its 1940 Act exemption.

We may in the future organize one or more subsidiaries that seek to rely on the 1940 Act exemption provided to certain structured financing vehicles by Rule 3a-7. Any such subsidiary would need to be structured to comply with any guidance that may be issued by the SEC staff on the restrictions contained in Rule 3a-7. We expect that the aggregate value of the operating partnership's interests in subsidiaries that seek to rely on Rule 3a-7 will comprise less than 20% of the operating partnership's (and, therefore, our) total assets on an unconsolidated basis.

In addition, we believe neither we nor our Operating Partnership will be considered an investment company under Section 3(a)(1)(A) of the 1940 Act because neither we nor our Operating Partnership will engage primarily or hold ourselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through our Operating Partnership's wholly-owned or majority-owned subsidiaries, we and our Operating Partnership will be primarily engaged in the non-investment company businesses of these subsidiaries, namely the business of purchasing or otherwise acquiring real property, mortgages and other interests in real estate.

Qualification for exemption from registration under the 1940 Act will limit our ability to make certain investments. For example, these restrictions will limit the ability of our subsidiaries to invest directly in mortgage-backed securities that represent less than the entire ownership in a pool of mortgage loans, debt and equity tranches of securitizations and certain asset-backed securities and real estate companies or in assets not related to real estate.

There can be no assurance that the laws and regulations governing the 1940 Act status of REITs, including the SEC staff providing more specific or different guidance regarding these exemptions, will not change in a manner that adversely affects our operations. The SEC recently solicited public comment on a wide range of issues relating to Section 3(c)(5)(C) and Rule 3a-7 of the 1940 Act, including the nature of the assets that qualify for purposes of the exemption and whether mortgage REITs should be regulated in a manner similar to investment companies. To the extent that the SEC staff provides more specific guidance regarding any of the matters bearing upon such exclusions, we may be required to adjust our strategy accordingly. Any additional guidance from the SEC staff

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could provide additional flexibility to us, or it could further inhibit our ability to pursue the strategies we have chosen. If we, the Operating Partnership or its subsidiaries fail to maintain an exception or exemption from the 1940 Act, we could, among other things, be required either to (a) change the manner in which we conduct our operations to avoid being required to register as an investment company, (b) effect sales of our assets in a manner that, or at a time when, we would not otherwise choose to do so, or (c) register as an investment company, any of which could negatively affect the value of our common stock, the sustainability of our business model, and our ability to make distributions which could have an adverse effect on our business and the market price for our shares of common stock.

***We may be adversely affected by the current and future economic, regulatory and other actions of the U.S. government and its agencies.***

In response to the ongoing financial crisis, the U.S. government, Federal Reserve, U.S. Treasury, Securities and Exchange Commission and other governmental and regulatory bodies have taken a number of economic actions and regulatory initiatives designed to stabilize and stimulate the economy and the financial markets, and we expect additional actions and initiatives in the future. These actions may include the development and implementation of programs that could result in a flattening in the yield curve and lower long-term interest rates, among other potential impacts. Lower long-term interest rates could result in increased prepayment rates and a narrowing of our net interest margin. Further, there can be no assurance that recent or future U.S. government actions will have the intended beneficial impact on the financial markets or that these actions will not negatively impact our business, results of operations or financial condition.

***We may change any of our strategies, policies or procedures without shareholder consent.***

We may change any of our strategies, policies or procedures with respect to investments, acquisitions, growth, operations, indebtedness, capitalization and distributions at any time without the consent of our shareholders, which could result in an investment portfolio with a different risk profile. A change in our investment strategy may increase our exposure to interest rate risk, default risk and real estate market fluctuations. Furthermore, a change in our asset allocation could result in our making investments in asset categories different from those described in this Report. These changes could adversely affect our financial condition, results of operations, the market price of our common stock and our ability to make distributions to our shareholders.

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*We are highly dependent on information systems and systems failures could significantly disrupt our business, which may, in turn, negatively affect the market price of our common stock and our ability to pay dividends.*

Our business is highly dependent on Invesco's communications and information systems. Any failure or interruption of Invesco's systems could cause delays or other problems in our securities trading activities, which could have a material adverse effect on our operating results and negatively affect the market price of our common stock and our ability to pay dividends to our shareholders.

### **Risks Related to Financing and Hedging**

*We use leverage in executing our business strategy, which may adversely affect the return on our assets and may reduce cash available for distribution to our shareholders, as well as increase losses when economic conditions are unfavorable.*

We use leverage to finance our assets through borrowings from repurchase agreements, and other secured and unsecured forms of borrowing and we contribute capital to equity investments. Although we are not required to maintain any particular debt-to-equity leverage ratio, the amount of leverage we may deploy for particular assets will depend upon our Manager's assessment of the credit and other risks of those assets.

The capital and credit markets have experienced extreme volatility and disruption since July 2007. In a large number of cases, the markets have exerted downward pressure on stock prices and credit capacity for issuers. Our access to capital depends upon a number of factors over which we have little or no control, including:

general market conditions;

the market's view of the quality of our assets;

the market's perception of our growth potential;

our eligibility to participate in and access capital from programs established by the U.S. government;

our current and potential future earnings and cash distributions; and

the market price of the shares of our capital stock.

Any weakness or volatility in the financial markets, the residential and commercial mortgage markets or 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. Current market conditions have affected different types of financing for mortgage-related assets to varying degrees, with some sources generally being unavailable, others being available but at a higher cost, while others being largely unaffected. For example, in the repurchase agreement market, non-Agency RMBS have been more difficult to finance than Agency RMBS. In connection with repurchase agreements, financing rates and advance rates, or haircut levels, have also increased. Repurchase agreement counterparties have taken these steps in order to compensate themselves for a perceived increased risk due to the illiquidity of the underlying collateral. In some cases, margin calls have forced borrowers to liquidate collateral in order to meet the capital requirements of these margin calls, resulting in losses.

The return on our assets and cash available for distribution to our shareholders may be reduced to the extent that market conditions prevent us from leveraging our assets or cause the cost of our financing to increase relative to the income that can be derived from the assets acquired. Our financing costs will reduce cash available for distributions to shareholders. We may not be able to meet our financing obligations and, to the extent that we cannot, we risk the loss of some or all of our assets to liquidation or sale to satisfy the obligations. We leverage our



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Agency RMBS, non-Agency RMBS and CMBS, through repurchase agreements. A decrease in the value of these assets may lead to margin calls which we will have to satisfy. We may not have the funds available to satisfy any such margin calls and may be forced to sell assets at significantly depressed prices due to market conditions or otherwise, which may result in losses. The satisfaction of such margin calls may reduce cash flow available for distribution to our shareholders. Any reduction in distributions to our shareholders may cause the value of our common stock to decline.

***As a result of current market events, including the contraction among and failure of certain lenders, it may be more difficult for us to secure financing.***

Our results of operations are materially affected by conditions in the financial markets and the economy generally. Recently, concerns over inflation, energy price volatility, geopolitical issues, unemployment, the availability and cost of credit, the mortgage market and a declining real estate market have contributed to increased market volatility.

Dramatic declines in the residential and commercial real estate markets, with decreasing home prices and increasing foreclosures and unemployment, have resulted in significant asset write-downs by financial institutions, which have caused many financial institutions to seek additional capital, to merge with other institutions and, in some cases, to fail. We rely on the availability of repurchase agreement financing to acquire our target assets. Institutions from which we seek to obtain financing may have owned or financed residential or commercial mortgage loans, real estate-related securities and real estate loans which have declined in value and caused losses as a result of the recent downturn in the markets. Many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers, including other financial institutions. If these conditions persist, these institutions may become insolvent. As a result of current market events, it may be more difficult for us to secure financing as there are fewer institutional lenders and those remaining lenders have tightened their lending standards. Our profitability may be adversely affected if we are unable to secure financing for our assets.

***If a counterparty to our repurchase transactions defaults on its obligation to resell the underlying security back to us at the end of the transaction term, or if the value of the underlying security has declined as of the end of that term, or if we default on our obligations under the repurchase agreement, we will lose money on our repurchase transactions.***

When we engage in repurchase transactions, we generally sell securities to lenders (repurchase agreement counterparties) and receive cash from these 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 may incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the securities). We would also lose money on a repurchase transaction if the value of the underlying securities has declined as of the end of the transaction term, as we would have to repurchase the securities for their initial value but would receive securities worth less than that amount. Further, if we default on one of our obligations under a repurchase transaction, the lender can terminate the transaction and cease entering into any other repurchase transactions with us. Some of our repurchase agreements contain cross-default provisions, so that if a default occurs under any one agreement, the lenders under our other agreements could also declare a default. Any losses we incur on our repurchase transactions could adversely affect our earnings and thus our cash available for distribution to our shareholders.

***Our use or future use of repurchase agreements to finance our target assets may give our lenders greater rights in the event that either we or a lender files for bankruptcy.***

Our borrowings or future borrowings under repurchase agreements for our target assets may qualify for special treatment under the U.S. Bankruptcy Code, giving our lenders the ability to avoid the automatic stay provisions of the U.S. Bankruptcy Code and to take possession of and liquidate the assets that we have pledged under their repurchase agreements without delay in the event that we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the U.S. Bankruptcy Code may make it difficult for us to recover our pledged assets in the event that a lender party to such agreement files for bankruptcy. Therefore, our use of repurchase agreements to finance our investments exposes our pledged assets to risk in the event of a bankruptcy filing by either a lender or us.



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*We depend on repurchase agreement financing to acquire our target assets and our inability to access this funding could have a material adverse effect on our results of operations, financial condition and business.*

We use repurchase agreement financing as a strategy to increase the return on our assets. However, we may not be able to achieve our desired leverage ratio for a number of reasons, including if the following events occur:

our lenders do not make repurchase agreement financing available to us at acceptable rates;

certain of our lenders exit the repurchase market;

our lenders require that we pledge additional collateral to cover our borrowings, which we may be unable to do; or

we determine that the leverage would expose us to excessive risk.

Our ability to fund our target assets may be impacted by our ability to secure repurchase agreement financing on acceptable terms. We can provide no assurance that lenders will be willing or able to provide us with sufficient financing. In addition, because repurchase agreements are short-term commitments of capital, lenders may respond to market conditions making it more difficult for us to secure continued financing. During certain periods of the credit cycle, lenders may curtail their willingness to provide financing. If major market participants were to exit the repurchase agreement financing business, the value of our portfolio could be negatively impacted, thus reducing net shareholder equity, or book value. Furthermore, if many of our current or potential lenders are unwilling or unable to provide us with repurchase agreement financing, we could be forced to sell our assets at an inopportune time when prices are depressed. In addition, if the regulatory capital requirements imposed on our lenders change, they may be required to significantly increase the cost of the financing that they provide to us. Our lenders also may revise their eligibility requirements for the types of assets they are willing to finance or the terms of such financings, based on, among other factors, the regulatory environment and their management of perceived risk, particularly with respect to assignee liability.

*Standard & Poor's downgrade in the credit rating of the U.S. government and the possibility of a further downgrade or additional downgrades by other credit rating agencies may have a material adverse effect on our business, financial condition and results of operations, as well as the price of our common stock.*

Standard & Poor's (S&P) downgrade in the credit rating of the U.S. government and the possibility of a further downgrade by S&P or additional downgrades by other credit rating agencies may have a material adverse effect on our business, financial condition and results of operations, as well as the price of our common stock. The impact on us of the downgrade and resulting financial market volatility may include, but not be limited to, the following:

The value of our assets may decline;

Since we utilize repurchase agreements which are secured by our assets, a decline in value of our assets may require us to post additional collateral to secure our debt;

Significant changes in interest rates may occur which may increase our borrowing costs, reduce advance rates on repurchase agreements and reduce our liquidity; and

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Such interest rate volatility may cause further decline in the value of our interest rate swaps causing us to post additional collateral.

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***Foreign financial market volatility and foreign governments' responses may negatively impact our results of operations, financial condition or business.***

Foreign financial markets have experienced significant volatility related to events such as the European debt crisis and their governments' responses. Such responses have included the implementation of various financial reforms including but not limited to development of the Basel III standards by the Basel Committee on Banking Supervision. The final package of Basel III reforms were approved by the G20 leaders in November 2010 and are subject to individual adoption by member nations, including the United States by January 1, 2013. Adoption of the Basel III standards by U.S. banking regulators would raise capital requirements for and could place capital constraints on the financial institutions from which we borrow possibly limiting our access to financing or affecting the terms of our future financing arrangements. Further, concerns regarding the financial weaknesses of the European Union sovereign nations could renew concerns of instability in financial systems worldwide. There can be no assurance that actions by foreign governments to stabilize the financial markets will be effective or that these actions and continued volatility will not negatively impact our results of operations, financial condition and business.

***The repurchase agreements that we use to finance our investments may require us to provide additional collateral and may restrict us from leveraging our assets as fully as desired.***

The amount of financing we receive, or may in the future receive, under our repurchase agreements is directly related to the lenders' valuation of the assets that secure the outstanding borrowings. Typically repurchase agreements grant the respective lender the absolute right to reevaluate the market value of the assets that secure outstanding borrowings at any time. If a lender determines in its sole discretion that the value of the assets has decreased, it has the right to initiate a margin call. A margin call would require us to transfer additional assets to such lender without any advance of funds from the lender for such transfer or to repay a portion of the outstanding borrowings. Any such margin call could have a material adverse effect on our results of operations, financial condition, business, liquidity and ability to make distributions to our shareholders, and could cause the value of our common stock to decline. We may be forced to sell assets at significantly depressed prices to meet such margin calls and to maintain adequate liquidity, which could cause us to incur losses. Moreover, to the extent we are forced to sell assets at such time, given market conditions, we may be selling at the same time as others facing similar pressures, which could exacerbate a difficult market environment and which could result in our incurring significantly greater losses on our sale of such assets. In an extreme case of market duress, a market may not even be present for certain of our assets at any price. Such a situation would likely result in a rapid deterioration of our financial condition and possibly necessitate a filing for bankruptcy protection.

Further, financial institutions providing the repurchase facilities may require us to maintain a certain amount of cash uninvested or to set aside non-levered assets sufficient to maintain a specified liquidity position which would allow us to satisfy our collateral obligations. As a result, we may not be able to leverage our assets as fully as we would choose which could reduce our return on equity. If we are unable to meet these collateral obligations, our financial condition could deteriorate rapidly.

***An increase in our borrowing costs relative to the interest we receive on investments in our target assets may adversely affect our profitability and our cash available for distribution to our shareholders.***

As our financings mature, we will be required either to enter into new borrowings or to sell certain of our investments. An increase in short-term interest rates at the time that we seek to enter into new borrowings would reduce the spread between our returns on our assets and the cost of our borrowings. This would adversely affect our returns on our assets, which might reduce earnings and, in turn, cash available for distribution to our shareholders.

***We enter into hedging transactions that could expose us to contingent liabilities in the future.***

Part of our investment strategy involves entering into hedging transactions that could require us to fund cash payments in certain circumstances (such as the early termination of the hedging instrument caused by an event of default or other early termination event, or the decision by a counterparty to request margin securities it is contractually owed under the terms of the hedging instrument). The amount due would be equal to the unrealized loss of the open swap positions with the respective counterparty and could also include other fees and charges.

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These economic losses will be reflected in our results of operations, and our ability to fund these obligations will depend on the liquidity of our assets and access to capital at the time, and the need to fund these obligations could adversely impact our financial condition.

*Hedging against interest rate exposure may adversely affect our earnings, which could reduce our cash available for distribution to our shareholders.*

We pursue various hedging strategies to seek to reduce our exposure to adverse changes in interest rates. 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. Interest rate hedging may fail to protect or could adversely affect us because, among other things:

interest rate hedging can be expensive, particularly during periods of rising and volatile interest rates;

available interest rate hedges may not correspond directly with the interest rate risk for which protection is sought;

due to a credit loss, the duration of the hedge may not match the duration of the related liability;

the amount of income that a REIT may earn from hedging transactions (other than hedging transactions that satisfy certain requirements of the Internal Revenue Code or that are done through a taxable REIT subsidiary ( TRS )) to offset interest rate losses is limited by U.S. federal tax provisions governing REITs;

the credit quality of the hedging counterparty owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and

the hedging counterparty owing money in the hedging transaction may default on its obligation to pay.

Our hedging transactions, which are intended to limit losses, may actually adversely affect our earnings, which could reduce our cash available for distribution to our shareholders.

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

*We may enter into derivative contracts that expose us to contingent liabilities and those contingent liabilities may not appear on our balance sheet. We may invest in synthetic securities, credit default swaps, and other credit derivatives, which expose us to additional risks.*

We have entered and may again in the future enter into derivative contracts that could require us to make cash payments in certain circumstances. Potential payment obligations would be contingent liabilities and may not appear on our balance sheet. Our ability to satisfy these contingent liabilities depends on the liquidity of our assets and our access to capital and cash. The need to fund these contingent liabilities could

adversely impact our financial condition.

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We may directly or through our equity investments, invest in synthetic securities, credit default swaps, and other credit derivatives that reference other real estate securities or indices. These investments may present risks in excess of those resulting from the referenced security or index. These investments are typically a contractual relationship with counterparties and not an acquisition of a referenced security or other asset. In these types of investments, we have no right to directly enforce compliance with the terms of the referenced security or other assets and we have no voting or other consensual rights of ownership with respect to the referenced security or other assets. In the event of insolvency of a counterparty, we will be treated as a general creditor of the counterparty and will have no claim of title with respect to the referenced security.

The markets for these types of investments have, in some cases, only existed for a few years and may not be liquid. Many of these investments incorporate pay as you go credit events which have been introduced into the market fairly recently. For example, the terms of credit default swaps are still evolving and may change significantly, which could make it more difficult to assign such an instrument or determine the loss pursuant to the underlying agreement. In a credit default swap, the party wishing to buy protection will pay a premium. When interest rates change, the spreads change, or the prevailing credit premiums on credit default swaps change, the amount of the termination payment due could change by a substantial amount. In an illiquid market, the determination of this change could be difficult to ascertain and, as a result, we may not achieve the desired benefit of entering into this contractual relationship. To date, we have entered into a limited number of these agreements. We may over time increase our exposure to these types of investments as the market for them grows and during times when acquiring other real estate loans and securities may be difficult. We may find credit default swaps and other forms of synthetic securities to be a more efficient method of providing credit-enhancement on specific pools of real estate loans. We will attempt to manage the risks associated with these investments including counterparty risks, but our efforts may prove to be insufficient in enabling us to generate the returns anticipated.

### **Risks Related to Accounting**

#### ***Reclassification of securities financed with repurchase agreements may adversely affect our reported profitability.***

In February 2008, the Financial Accounting Standards Board ( FASB ) issued final guidance regarding the accounting and financial statement presentation for transactions that involve the acquisition of securities from a counterparty and the subsequent financing of these securities through repurchase agreements with the same counterparty. If we fail to meet the criteria under guidance to account for the transactions on a gross basis, our accounting treatment would not affect the economics of these transactions, but would affect how these transactions are reported on our financial statements. If we are not able to comply with the criteria under this final guidance for same party transactions we would be precluded from presenting the securities and the related financings, as well as the related interest income and interest expense, on a gross basis on our financial statements. Instead, we would be required to account for the purchase commitment and related repurchase agreement on a net basis and record a forward commitment to purchase securities as a derivative instrument. Such forward commitments would be recorded at fair value with subsequent changes in fair value recognized in earnings. Additionally, we would record the cash portion of our investment in the security as a mortgage-related receivable from the counterparty on our balance sheet. Although we would not expect this change in presentation to have a material impact on our net income, it could have an adverse impact on our operations. It could have an impact on our ability to include certain securities purchased and simultaneously financed from the same counterparty as qualifying real estate interests or real estate-related assets used to qualify under the exemption to not have to register as an investment company under the 1940 Act. It could also limit our investment opportunities as we may need to limit our purchases of securities that are simultaneously financed with the same counterparty.

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*We may fail to qualify for hedge accounting treatment.*

We enter into derivative transactions to reduce the impact that changes in interest rates will have on our net interest margin. According to our accounting policy, we record these derivatives, known as cash flow hedges, on the balance sheet at fair market value with the changes in value recorded in equity as other comprehensive income. This hedge accounting is complex and requires documentation and testing to ensure the hedges are effective. If we fail to qualify for hedge accounting treatment, our operating results may suffer because losses on hedges will be recorded in current period earnings rather than through other comprehensive income.

*The preparation of our financial statements involves use of estimates, judgments and assumptions, and our financial statements may be materially affected if our estimates prove to be inaccurate.*

Financial statements prepared in accordance with Accounting Principles Generally Accepted in the United States of America ( US GAAP ) require the use of estimates, judgments and assumptions that affect the reported amounts. Different estimates, judgments and assumptions reasonably could be used that would have a material effect on the financial statements, and changes in these estimates, judgments and assumptions are likely to occur from period to period in the future. Significant areas of accounting requiring the application of management's judgment include, but are not limited to determining the fair value of investment securities. These estimates, judgments and assumptions are inherently uncertain, and, if they prove to be wrong, then we face the risk that charges to income will be required. In addition, because we have limited operating history in some of these areas and limited experience in making these estimates, judgments and assumptions, the risk of future charges to income may be greater than if we had more experience in these areas. Any such charges could significantly harm our business, financial condition, results of operations and the price of our securities. See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies for a discussion of the accounting estimates, judgments and assumptions that we believe are the most critical to an understanding of our business, financial condition and results of operations.

**Risks Related to Our Investments**

*We may allocate our equity to investments with which our shareholders may not agree.*

Our shareholders will be unable to evaluate the manner in which our equity will be invested or the economic merit of our expected investments and, as a result, we may use our equity to invest in investments with which our shareholders may not agree. The failure of our management to apply our equity effectively or find investments that meet our investment criteria in sufficient time or on acceptable terms could result in unfavorable returns, could cause a material adverse effect on our business, financial condition, liquidity, results of operations and ability to make distributions to our shareholders, and could cause the value of our common stock to decline.

*Because assets we acquire may experience periods of illiquidity, we may lose profits or be prevented from earning capital gains if we cannot sell mortgage-related assets at an opportune time.*

We bear the risk of being unable to dispose of our target assets at advantageous times or in a timely manner because mortgage-related assets generally experience periods of illiquidity, including the recent period of delinquencies and defaults with respect to residential and commercial mortgage loans. The lack of liquidity may result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale or the unavailability of financing for these assets. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be relatively limited, which may cause us to incur losses.

*The lack of liquidity in our investments may adversely affect our business.*

Some of the assets that comprise our investment portfolio and that we acquire are not publicly traded. A portion of these securities may be subject to legal and other restrictions on resale or will otherwise be less liquid than publicly-traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio

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quickly, we may realize significantly less than the value at which we have previously recorded our investments. Further, we may face other restrictions on our ability to liquidate an investment in a business entity to the extent that we or our Manager has or could be attributed with material, non-public information regarding such business entity. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be relatively limited, which could adversely affect our results of operations and financial condition.

*Our investments may be concentrated and will be subject to risk of default.*

While we diversify and intend to continue to diversify our portfolio of investments in the manner described in this Report, we are not required to observe specific diversification criteria, except as may be set forth in the investment guidelines adopted by our board of directors. Therefore, our investments in our target assets may at times be concentrated in certain property types that are subject to higher risk of foreclosure, or secured by properties concentrated in a limited number of geographic locations. To the extent that our portfolio is concentrated in any one region or type of security, downturns relating generally to such region or type of security may result in defaults on a number of our investments within a short time period, which may reduce our net income and the value of our common stock and accordingly reduce our ability to pay dividends to our shareholders.

*Difficult conditions in the mortgage, residential and commercial real estate markets may cause us to experience market losses related to our holdings.*

Our results of operations are materially affected by conditions in the mortgage market, the residential and commercial real estate markets, the financial markets and the economy generally. Recently, concerns about the mortgage market and a declining real estate market, as well as inflation, energy costs, geopolitical issues and the availability and cost of credit, have contributed to increased market volatility. The mortgage market has been severely affected by changes in the lending landscape and there is no assurance that these conditions have stabilized or that they will not worsen. The disruption in the mortgage market has an impact on new demand for homes, which will compress the home ownership rates and weigh heavily on future home price performance. There is a strong correlation between home price growth rates and mortgage loan delinquencies. The further deterioration of the RMBS market may cause us to experience losses related to our assets and to sell assets at a loss. Declines in the market values of our investments may adversely affect our results of operations and credit availability, which may reduce earnings and, in turn, cash available for distribution to our shareholders.

Dramatic declines in the residential and commercial real estate markets, with decreasing home prices and increasing foreclosures and unemployment, have resulted in significant asset write-downs by financial institutions, which have caused many financial institutions to seek additional capital, to merge with other institutions and, in some cases, to fail. Institutions from which we seek to obtain financing may have owned or financed residential or commercial mortgage loans, real estate-related securities and real estate loans which have declined in value and caused losses as a result of the recent downturn in the markets. Many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers, including other financial institutions. If these conditions persist, these institutions may become insolvent. As a result of current market events, it may be more difficult for us to secure financing as there are fewer institutional lenders and those remaining lenders have tightened their lending standards. Our profitability may be adversely affected if we are unable to secure financing for our assets.

*Continued adverse developments in the residential and commercial mortgage markets, including recent increases in defaults, credit losses and liquidity concerns, could make it difficult for us to borrow money to acquire our target assets on a leveraged basis, on attractive terms or at all, which could adversely affect our profitability.*

Since mid-2008, there have been several announcements of proposed mergers, acquisitions or bankruptcies of investment banks and commercial banks that have historically acted as repurchase agreement counterparties. This has resulted in a fewer number of potential repurchase agreement counterparties operating in the market. In addition, many commercial banks, investment banks and insurance companies have announced extensive losses from exposure to the residential and commercial mortgage markets. These losses have reduced financial industry capital, leading to reduced liquidity for some institutions. Many of these institutions may have owned or financed assets which have declined in value and caused them to suffer losses, enter bankruptcy proceedings, further tighten their lending standards or increase the amount of equity capital or haircut required to obtain financing. These difficulties



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have resulted in part from declining markets for their mortgage loans as well as from claims for repurchases of mortgage loans previously sold under provisions that require repurchase in the event of early payment defaults or for breaches of representations regarding loan quality. The general market conditions discussed above may make it difficult or more expensive for us to obtain financing on attractive terms or at all, and our profitability may be adversely affected if we were unable to obtain cost-effective financing for our investments.

*We operate in a highly competitive market for investment opportunities and competition may limit our ability to acquire desirable investments in our target assets and could also affect the pricing of these securities.*

We operate in a highly competitive market for investment opportunities. Our profitability depends, in large part, on our ability to acquire our target assets at attractive prices. In acquiring our target assets, we compete with a variety of institutional investors, including other REITs, specialty finance companies, public and private funds (including other funds managed by Invesco), commercial and investment banks, commercial finance and insurance companies and other financial institutions. Many of our competitors are substantially larger and have considerably greater financial, technical, marketing and other resources than we do. Several other REITs have recently raised, or are expected to raise, significant amounts of capital, and may have investment objectives that overlap with ours, which may create additional competition for investment opportunities. Some competitors may have a lower cost of funds and access to funding sources that may not be available to us, such as funding from the U.S. government, if we are not eligible to participate in programs established by the U.S. government. Many of our competitors are not subject to the operating constraints associated with REIT tax compliance or maintenance of an exemption from the 1940 Act. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships. Furthermore, competition for investments in our target assets may lead to the price of such assets increasing, which may further limit our ability to generate desired returns. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, desirable investments in our target assets may be limited in the future and we may not be able to take advantage of attractive investment opportunities from time to time, as we can provide no assurance that we will be able to identify and make investments that are consistent with our investment objectives.

*We invest in non-Agency RMBS collateralized by Alt A and subprime mortgage loans, which are subject to increased risks.*

We invest in non-Agency RMBS backed by collateral pools of mortgage loans that have been originated using underwriting standards that are less restrictive than those used in underwriting prime mortgage loans and Alt A mortgage loans. These lower standards include mortgage loans made to borrowers having imperfect or impaired credit histories, mortgage loans where the amount of the loan at origination is 80% or more of the value of the mortgage property, mortgage loans made to borrowers with low credit scores, mortgage loans made to borrowers who have other debt that represents a large portion of their income and mortgage loans made to borrowers whose income is not required to be disclosed or verified. Due to economic conditions, including increased interest rates and lower home prices, as well as aggressive lending practices, subprime mortgage loans have in recent periods experienced increased rates of delinquency, foreclosure, bankruptcy and loss, and they are likely to continue to experience delinquency, foreclosure, bankruptcy and loss rates that are higher, and that may be substantially higher, than those experienced by mortgage loans underwritten in a more traditional manner. Thus, because of the higher delinquency rates and losses associated with subprime mortgage loans, the performance of non-Agency RMBS backed by subprime mortgage loans that we may acquire could be correspondingly adversely affected, which could adversely impact our results of operations, financial condition and business.

*We acquire mortgage-backed securities and loans that are subject to defaults, foreclosure timeline extension, fraud and residential and commercial price depreciation, and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.*

Residential mortgage-backed securities are secured by mortgage loans on primarily single family residential property or a pool of residential mortgage loans. Accordingly, the RMBS we invest in are subject to all risks of the respective underlying residential mortgage loans including risks of defaults, foreclosure timeline extension, fraud and home price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, accompanying the underlying residential mortgage loans. The ability of a borrower to repay a mortgage loan secured by a residential property is dependent upon the income or assets of the borrower. A number of factors may impair a borrower's ability to repay their loans, including but not limited to:

acts of God, including earthquakes, floods and other natural disasters, which may result in uninsured losses;



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acts of war or terrorism, including the consequences of terrorist attacks;

adverse changes in national and local economic and market conditions;

changes in governmental laws and regulations, fiscal policies and zoning ordinances and the related costs of compliance with laws and regulations, fiscal policies and ordinances;

costs of remediation and liabilities associated with environmental conditions such as indoor mold; and

the potential for uninsured or under-insured property losses.

In the event of any default under a mortgage loan held directly by us, we bear a risk of loss of principal to the extent of any deficiency between the value of the collateral and the principal and accrued interest of the mortgage loan, which could have a material adverse effect on our cash flow from operations. In the event of defaults on the residential mortgage loans that underlie our investments and the exhaustion of any underlying or any additional credit support, we may not realize our anticipated return on our investments and we may incur a loss on these investments.

In the event of the bankruptcy of a mortgage loan borrower, the mortgage loan to such borrower will be deemed to be secured only to the extent of the value of the underlying collateral at the time of bankruptcy (as determined by the bankruptcy court), and the lien securing the mortgage loan will be subject to the avoidance powers of the bankruptcy trustee or debtor in possession to the extent the lien is unenforceable under state law. Foreclosure of a mortgage loan can be an expensive and lengthy process which could have a substantial negative effect on our anticipated return on the foreclosed mortgage loan.

***The commercial mortgage loans we acquire and the commercial mortgage loans underlying the CMBS we acquire will be subject to defaults, foreclosure timeline extension, fraud and price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal.***

CMBS are secured by a single commercial mortgage loan or a pool of commercial mortgage loans. Accordingly, the CMBS we invest in are subject to all of the risks of the respective underlying commercial mortgage loans. Commercial mortgage loans are secured by multifamily or commercial property and are subject to risks of delinquency and foreclosure, and risks of loss that may be greater than similar risks associated with loans made on the security of single-family residential property. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. If the net operating income of the property is reduced, the borrower's ability to repay the loan may be impaired. Net operating income of an income-producing property can be affected by, among other things:

tenant mix;

success of tenant businesses;

property management decisions;

property location and condition;

competition from comparable types of properties;

changes in laws that increase operating expenses or limit rents that may be charged;

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any need to address environmental contamination at the property or the occurrence of any uninsured casualty at the property;

changes in national, regional or local economic conditions and/or specific industry segments;

declines in regional or local real estate values;

declines in regional or local rental or occupancy rates;

increases in interest rates;

real estate tax rates and other operating expenses;

changes in governmental rules, regulations and fiscal policies, including environmental legislation; and

acts of God, terrorist attacks, social unrest and civil disturbances.

In the event of any default under a mortgage loan held directly by us, we will bear a risk of loss of principal to the extent of any deficiency between the value of the collateral and the principal and accrued interest of the mortgage loan, which could have a material adverse effect on our cash flow from operations and limit amounts available for distribution to our shareholders. In the event of the bankruptcy of a mortgage loan borrower, the mortgage loan to such borrower will be deemed to be secured only to the extent of the value of the underlying collateral at the time of bankruptcy (as determined by the bankruptcy court), and the lien securing the mortgage loan will be subject to the avoidance powers of the bankruptcy trustee or debtor-in-possession to the extent the lien is unenforceable under state law. Foreclosure of a mortgage loan can be an expensive and lengthy process, which could have a substantial negative effect on our anticipated return on the foreclosed mortgage loan.

***Our investments in CMBS are generally subject to losses.***

We acquire CMBS. In general, losses on a mortgaged property securing a mortgage loan included in a securitization will be borne first by the equity holder of the property, then by a cash reserve fund or letter of credit, if any, then by the holder of a mezzanine loan or B-Note, if any, then by the first loss subordinated security holder (generally, the B-Piece buyer) and then by the holder of a higher-rated security. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit, mezzanine loans or B-Notes, and any classes of securities junior to those in which we invest, we will not be able to recover all of our investment in the securities we purchase. In addition, if the underlying mortgage portfolio has been overvalued by the originator, or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related CMBS. The prices of lower credit quality securities are generally less sensitive to interest rate changes than more highly rated investments, but more sensitive to adverse economic downturns or individual issuer developments.

***We may not control the special servicing of the mortgage loans included in the CMBS in which we invest and, in such cases, the special servicer may take actions that could adversely affect our interests.***

With respect to each series of CMBS in which we invest, overall control over the special servicing of the related underlying mortgage loans is held by a directing certificate holder or a controlling class representative, which is appointed by the holders of the most subordinate class of CMBS in such series. Since we predominantly focus on acquiring classes of existing series of CMBS originally rated AAA, we may not have the right to appoint the directing certificate holder. In connection with the servicing of the specially serviced mortgage loans, the related special servicer may, at the direction of the directing certificate holder, take actions with respect to the specially serviced mortgage loans that could adversely affect our interests.



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*If our Manager underestimates the collateral loss on our investments, we may experience losses.*

Our Manager values our potential investments based on loss-adjusted yields, taking into account estimated future losses on the mortgage loans included in the securitization's pool of loans, and the estimated impact of these losses on expected future cash flows. Based on these loss estimates, our Manager may adjust the pool composition accordingly through loan removals and other credit enhancement mechanisms or leave loans in place and negotiate for a price adjustment. Our Manager's loss estimates may not prove accurate, as actual results may vary from estimates. In the event that our Manager underestimates the pool level losses relative to the price we pay for a particular investment, we may experience losses with respect to such investment.

*The B-Notes we acquire are subject to additional risks related to the privately negotiated structure and terms of the transaction, which may result in losses to us.*

We may acquire B-Notes, mortgage loans typically (i) secured by a first mortgage on a single large commercial property or group of related properties, and (ii) subordinated to an A-Note secured by the same first mortgage on the same collateral. As a result, if a borrower defaults, there may not be sufficient funds remaining for B-Note holders after payment to the A-Note holders. However, because each transaction is privately negotiated, B-Notes can vary in their structural characteristics and risks. For example, the rights of holders of B-Notes to control the process following a borrower default may vary from transaction to transaction. Further, B-Notes typically are secured by a single property and so reflect the risks associated with significant concentration. Significant losses related to our B-Notes would result in operating losses for us and may limit our ability to make distributions to our shareholders.

*Our mezzanine loan assets involve greater risks of loss than senior loans secured by income-producing properties.*

We may acquire mezzanine loans, which take the form of subordinated loans secured by second mortgages on the underlying property or loans secured by a pledge of the ownership interests of either the entity owning the property or a pledge of the ownership interests of the entity that owns the interest in the entity owning the property. These types of assets involve a higher degree of risk than long-term senior mortgage lending secured by income-producing real property, because the loan may become unsecured as a result of foreclosure by the senior lender. In the event of a bankruptcy of the entity providing the pledge of its ownership interests as security, we may not have full recourse to the assets of such entity, or the assets of the entity may not be sufficient to satisfy our mezzanine loan. If a borrower defaults on our mezzanine loan or debt senior to our loan, or in the event of a borrower bankruptcy, our mezzanine loan will be satisfied only after the senior debt. As a result, we may not recover some or all of our initial expenditure. In addition, mezzanine loans may have higher loan-to-value ratios than conventional mortgage loans, resulting in less equity in the property and increasing the risk of loss of principal. Significant losses related to our mezzanine loans would result in operating losses for us and may limit our ability to make distributions to our shareholders.

*Bridge loans involve a greater risk of loss than traditional investment-grade mortgage loans with fully insured borrowers.*

We may acquire bridge loans secured by first lien mortgages on a property to borrowers who are typically seeking short-term capital to be used in an acquisition, construction or redevelopment of a property. The borrower has usually identified an undervalued asset that has been under-managed and/or is located in a recovering market. If the market in which the asset is located fails to recover according to the borrower's projections, or if the borrower fails to improve the quality of the asset's management and/or the value of the asset, the borrower may not receive a sufficient return on the asset to satisfy the bridge loan, and we bear the risk that we may not recover some or all of our initial expenditure.

In addition, borrowers usually use the proceeds of a conventional mortgage to repay a bridge loan. Bridge loans therefore are subject to risks of a borrower's inability to obtain permanent financing to repay the bridge loan. Bridge loans are also subject to risks of borrower defaults, bankruptcies, fraud, losses and special hazard losses that are not covered by standard hazard insurance. In the event of any default under bridge loans held by us, we bear the risk of loss of principal and non-payment of interest and fees to the extent of any deficiency between the value of the mortgage collateral and the principal amount of the bridge loan. To the extent we suffer such losses with respect to our bridge loans, the value of our company and the price of our shares of common stock may be adversely affected.

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***Fluctuations in interest rates could adversely affect the value of our investments and cause our interest expense to increase, which could result in reduced earnings, affect our profitability and dividends as well as the cash available for distribution to our shareholders.***

We invest in Agency RMBS, non-Agency RMBS, CMBS and mortgage loans. The relationship between short-term and longer-term interest rates is often referred to as the yield curve. In a normal yield curve environment, an investment in such assets will generally decline in value if long-term interest rates increase. Declines in market value may ultimately reduce earnings or result in losses to us, which may negatively affect cash available for distribution to our shareholders.

A significant risk associated with our target assets is the risk that both long-term and short-term interest rates will increase significantly. If long-term rates increased significantly, the market value of these investments would decline, and the duration and weighted average life of the investments would increase. We could realize a loss if the securities were sold. At the same time, an increase in short-term interest rates would increase the amount of interest owed on the repurchase agreements we enter into to finance the purchase of our investments.

Market values of our investments may decline without any general increase in interest rates for a number of reasons, such as increases or expected increases in defaults, or increases or expected increases in voluntary prepayments for those investments that are subject to prepayment risk or widening of credit spreads.

In addition, in a period of rising interest rates, our operating results will depend in large part on the difference between the income from our assets and financing costs. We anticipate that, in most cases, the income from such assets will respond more slowly to interest rate fluctuations than the cost of our borrowings. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net income. Increases in these rates will tend to decrease our net income and market value of our assets.

***An increase in interest rates may cause a decrease in the volume of certain of our target assets which could adversely affect our ability to acquire target assets that satisfy our investment objectives and to generate income and pay dividends.***

Rising interest rates generally reduce the demand for mortgage loans due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of target assets available to us, which could adversely affect our ability to acquire assets that satisfy our investment objectives. Rising interest rates may also cause our target assets that were issued prior to an interest rate increase to provide yields that are below prevailing market interest rates. If rising interest rates cause us to be unable to acquire a sufficient volume of our target assets with a yield that is above our borrowing cost, our ability to satisfy our investment objectives and to generate income and pay dividends may be materially and adversely affected.

Ordinarily, short-term interest rates are lower than longer-term interest rates. If short-term interest rates rise disproportionately relative to longer-term interest rates (a flattening of the yield curve), our borrowing costs may increase more rapidly than the interest income earned on our assets. Because we expect our investments, on average, generally will bear interest based on longer-term rates than our borrowings, a flattening of the yield curve would tend to decrease our net income and the market value of our net assets. Additionally, to the extent cash flows from investments that return scheduled and unscheduled principal are reinvested, the spread between the yields on the new investments and available borrowing rates may decline, which would likely decrease our net income. It is also possible that short-term interest rates may exceed longer-term interest rates (a yield curve inversion), in which event our borrowing costs may exceed our interest income and we could incur operating losses.

***Interest rate fluctuations may adversely affect the level of our net income and the value of our assets and common stock.***

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Interest rate



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fluctuations present a variety of risks, including the risk of a narrowing of the difference between asset yields and borrowing rates, flattening or inversion of the yield curve and fluctuating prepayment rates, and may adversely affect our income and the value of our assets and common stock.

#### ***We may experience a decline in the market value of our assets and interest rate swaps.***

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

#### ***Some of our portfolio investments are recorded at estimated fair value and, as a result, there is uncertainty as to the value of these investments.***

Some of our portfolio investments are in the form of securities that are not publicly traded. The fair value of securities and other investments that are not publicly traded may not be readily determinable. We value these investments quarterly at fair value, which may include unobservable inputs. Because such valuations are subjective, the fair value of certain of our assets may fluctuate over short periods of time and our determinations of fair value may differ materially from the values that would have been used if a ready market for these securities existed. The value of our common stock could be adversely affected if our determinations regarding the fair value of these investments were materially higher than the values that we ultimately realize upon their disposal.

#### ***Prepayment rates may adversely affect the value of our investment portfolio.***

Pools of residential mortgage loans underlie the RMBS that we acquire. In the case of residential mortgage loans, there are seldom any restrictions on borrowers' abilities to prepay their loans. We generally receive payments from principal payments that are made on these underlying mortgage loans. When borrowers prepay their mortgage loans faster than expected, this results in prepayments that are faster than expected on the RMBS. Faster than expected prepayments could adversely affect our profitability, including in the following ways:

We may purchase RMBS that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we may pay a premium over the par value to acquire the security. In accordance with US GAAP, we may amortize this premium over the estimated term of the RMBS. If the RMBS is prepaid in whole or in part prior to its maturity date, however, we may be required to expense the premium that was prepaid at the time of the prepayment.

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

If we are unable to acquire new RMBS similar to the prepaid RMBS, our financial condition, results of operation and cash flow would suffer. Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayment rates also may be affected by conditions in the housing and financial markets, general economic conditions and the relative interest rates on FRMs and ARMs.

While we seek to minimize prepayment risk to the extent practical, in selecting investments we must balance prepayment risk against other risks and the potential returns of each investment. No strategy can completely insulate us from prepayment risk.



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*Recent market conditions may upset the historical relationship between interest rate changes and prepayment trends, which would make it more difficult for us to analyze our investment portfolio.*

Our success depends on our ability to analyze the relationship of changing interest rates on prepayments of the mortgage loans that underlie our RMBS and mortgage loans we acquire. Changes in interest rates and prepayments affect the market price of the target assets. As part of our overall portfolio risk management, we analyze interest rate changes and prepayment trends separately and collectively to assess their effects on our investment portfolio. In conducting our analysis, we depend on certain assumptions based upon historical trends with respect to the relationship between interest rates and prepayments under normal market conditions. If the recent dislocations in the mortgage market or other developments change the way that prepayment trends have historically responded to interest rate changes, our ability to (1) assess the market value of our investment portfolio, (2) implement our hedging strategies, and (3) implement techniques to reduce our prepayment rate volatility would be significantly affected, which could materially adversely affect our financial position and results of operations.

**Risks Related to Our Common Stock**

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

The market price of our common stock may be highly volatile and be subject to wide fluctuations. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. If the market price of our common stock declines significantly, our shareholders may be unable to resell their shares at or above the price our shareholders paid for their shares. We cannot assure you that the market price of our common stock will not fluctuate or decline significantly in the future. Some of the factors that could negatively affect our share price or result in fluctuations in the price or trading volume of our common stock include:

actual or anticipated variations in our quarterly operating results or distributions;

changes in our earnings estimates or publication of research reports about us or the real estate or specialty finance industry;

decrease in the market valuations of our target assets;

increased difficulty in maintaining or obtaining financing or attractive terms, or at all;

increases in market interest rates that lead purchasers of our shares of common stock to demand a higher yield;

changes in market valuations of similar companies;

adverse market reaction to any increased indebtedness we incur in the future;

additions or departures of key management personnel;

actions by institutional shareholders;

speculation in the press or investment community; and

general market and economic conditions.

***Common stock eligible for future sale may have adverse effects on our share price.***

We cannot predict the effect, if any, of future sales of our common stock, or the availability of shares for future sales, on the market price of our common stock. Sales of substantial amounts of common stock or the perception that such sales could occur may adversely affect the prevailing market price for our common stock.

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Also, we may issue additional shares in public offerings or private placements to make new investments or for other purposes. We are not required to offer any such shares to existing shareholders on a preemptive basis. Therefore, it may not be possible for existing shareholders to participate in such future share issuances, which may dilute the existing shareholders' interests in us.

*We have not established a minimum distribution payment level, and we cannot assure our shareholders of our ability to pay distributions in the future.*

We pay quarterly distributions and make other distributions to our shareholders in an amount such that we distribute all or substantially all of our REIT taxable income in each year, subject to certain adjustments. We have not established a minimum distribution payment level and our ability to pay distributions may be adversely affected by a number of factors, including the risk factors described in this Report. All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, debt covenants, maintenance of our REIT qualification, applicable provisions of Maryland law and other factors as our board of directors may deem relevant from time to time. We believe that a change in any one of the following factors could adversely affect our results of operations and impair our ability to pay distributions to our shareholders:

our ability to make profitable investments;

margin calls or other expenses that reduce our cash flow;

defaults in our asset portfolio or decreases in the value of our portfolio; and

the fact that anticipated operating expense levels may not prove accurate, as actual results may vary from estimates. We cannot assure our shareholders that we will achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions in the future. In addition, some of our distributions may include a return in capital.

*Investing in our common stock may involve a high degree of risk.*

The investments we make in accordance with our investment objectives may result in a high amount of risk when compared to alternative investment options and volatility or loss of principal. Our investments may be highly speculative and aggressive, and therefore an investment in our common stock may not be suitable for someone with lower risk tolerance.

*Future offerings of debt or equity securities, which would rank senior to our common stock, may adversely affect the market price of our common stock.*

If we decide to issue debt or equity securities in the future, which would rank senior to our common stock, it is likely that they will be governed by an indenture or other instrument containing covenants restricting our operating flexibility. Additionally, any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock and may result in dilution to owners of our common stock. We and, indirectly, our shareholders, will bear the cost of issuing and servicing such securities. Because our decision to issue debt or equity securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus holders of our common stock will bear the risk of our future offerings reducing the market price of our common stock and diluting the value of their stock holdings in us.

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**Risks Related to Our Organization and Structure**

***Certain provisions of Maryland law could inhibit changes in control.***

Certain provisions of the Maryland General Corporation Law (the "MGCL"), may have the effect of deterring a third party from making a proposal to acquire us or of impeding a change in control under circumstances that otherwise could provide the holders of our common stock with the opportunity to realize a premium over the then-prevailing market price of our common stock. Under the MGCL, certain business combinations (including a merger, consolidation, share exchange, or, in circumstances specified in the statute, an asset transfer or issuance or reclassification of equity securities) between us and an interested shareholder (defined generally as any person who beneficially owns 10% or more of our then outstanding voting capital stock or an affiliate or associate of ours who, at any time within the two-year period prior to the date in question, was the beneficial owner of 10% or more of our then outstanding voting capital stock) or an affiliate thereof are prohibited for five years after the most recent date on which the shareholder becomes an interested shareholder. After the five-year prohibition, any business combination between us and an interested shareholder generally must be recommended by our board of directors and approved by the affirmative vote of at least (1) 80% of the votes entitled to be cast by holders of outstanding shares of our voting capital stock; and (2) two-thirds of the votes entitled to be cast by holders of voting capital stock of the corporation other than shares held by the interested shareholder with whom or with whose affiliate the business combination is to be effected or held by an affiliate or associate of the interested shareholder. These super-majority vote requirements do not apply if our common shareholders receive a minimum price, as defined under Maryland law, for their shares in the form of cash or other consideration in the same form as previously paid by the interested shareholder for its shares. These provisions of the MGCL do not apply, however, to business combinations that are approved or exempted by a board of directors prior to the time that the interested shareholder becomes an interested shareholder. Pursuant to the statute, our board of directors has by resolution exempted business combinations between us and any other person, provided that such business combination is first approved by our board of directors (including a majority of our directors who are not affiliates or associates of such person).

The control share provisions of the MGCL provide that control shares of a Maryland corporation (defined as shares which, when aggregated with other shares controlled by the shareholder (except solely by virtue of a revocable proxy), entitle the shareholder to exercise one of three increasing ranges of voting power in electing directors) acquired in a control share acquisition (defined as the direct or indirect acquisition of ownership or control of control shares) have no voting rights except to the extent approved by our shareholders by the affirmative vote of at least two-thirds of all the votes entitled to be cast on the matter, excluding votes entitled to be cast by the acquiror of control shares, our officers and our employees who are also our directors. Our bylaws contain a provision exempting from the control share acquisition statute any and all acquisitions by any person of shares of our stock. There can be no assurance that this provision will not be amended or eliminated at any time in the future.

The unsolicited takeover provisions of the MGCL permit our board of directors, without shareholder approval and regardless of what is currently provided in our charter or bylaws, to implement takeover defenses, some of which (for example, a classified board) we do not yet have. These provisions may have the effect of inhibiting a third party from making an acquisition proposal for us or of delaying, deferring or preventing a change in control of us under circumstances that otherwise could provide the holders of shares of common stock with the opportunity to realize a premium over the then current market price. Our charter contains a provision whereby we have elected to be subject to the provisions of Title 3, Subtitle 8 of the MGCL relating to the filling of vacancies on our board of directors.

***Our authorized but unissued shares of common and preferred stock may prevent a change in our control.***

Our charter authorizes us to issue additional authorized but unissued shares of common or preferred stock. In addition, our board of directors may, without shareholder approval, amend our charter to increase the aggregate number of our shares of stock or the number of shares of stock of any class or series that we have authority to issue and classify or reclassify any unissued shares of common or preferred stock and set the preferences, rights and other terms of the classified or reclassified shares. As a result, our board of directors may establish a series of shares of common or preferred stock that could delay or prevent a transaction or a change in control that might involve a premium price for our shares of common stock or otherwise be in the best interest of our shareholders.

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***We are the sole general partner of our Operating Partnership and could become liable for the debts and other obligations of our Operating Partnership beyond the amount of our initial expenditure.***

We are the sole general partner of our Operating Partnership. As the sole general partner, we are liable for our Operating Partnership's debts and other obligations. Therefore, if our Operating Partnership is unable to pay its debts and other obligations, we will be liable for such debts and other obligations beyond the amount of our expenditure for ownership interests in our Operating Partnership. These obligations could include unforeseen contingent liabilities and could materially adversely affect our financial condition, operating results and ability to make distributions to our shareholders.

***Ownership limitations may restrict change of control of business combination opportunities in which our shareholders might receive a premium for their shares.***

In order for us to qualify as a REIT for each taxable year after 2008, no more than 50% in value of our outstanding capital stock may be owned, directly or indirectly, by five or fewer individuals during the last half of any calendar year. Individuals for this purpose include natural persons, private foundations, some employee benefit plans and trusts, and some charitable trusts. To preserve our REIT qualification, among other purposes, our charter generally prohibits any person from directly or indirectly owning more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our capital stock or more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our common stock. This ownership limitation could have the effect of discouraging a takeover or other transaction in which holders of our common stock might receive a premium for their shares over the then prevailing market price or which holders might believe to be otherwise in their best interests. Different ownership limits will apply to Invesco. These ownership limits, which our board of directors has determined will not jeopardize our REIT qualification, will allow Invesco to hold up to 25% of our outstanding common stock or up to 25% of our outstanding capital stock.

**Tax Risks**

***Investment in our common stock investment has various U.S. federal income tax risks.***

This summary of certain tax risks is limited to the U.S. federal tax risks addressed below. Additional risks or issues may exist that are not addressed in this Report and that could affect the U.S. federal income tax treatment of us or our shareholders.

We strongly urge you to seek advice based on your particular circumstances from an independent tax advisor concerning the effects of U.S. federal, state and local income tax law on an investment in our common stock and on your individual tax situation.

***Our failure to qualify as a REIT would subject us to U.S. federal income tax and potentially increased state and local taxes, which would reduce the amount of cash available for distribution to our shareholders.***

We have been organized and we operate in a manner that enabled us to qualify as a REIT for U.S. federal income tax purposes commencing with our taxable year ended December 31, 2009. We intend to continue to operate in a manner so as to qualify as a REIT for federal income tax purposes. However, qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial and administrative interpretations exist. Even an inadvertent or technical mistake could jeopardize our REIT status. Our continued qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership, and other requirements on a continuing basis.

Moreover, new legislation, court decisions or administrative guidance, in each case possibly with retroactive effect, may make it more difficult or impossible for us to qualify as a REIT. Thus, while we intend to operate so that we will qualify as a REIT, given the highly complex nature of the rules governing REITs, the ongoing importance of factual determinations, and the possibility of future changes in our circumstances, no assurance can be given that we will so qualify for any particular year.

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

***Complying with REIT requirements may cause us to forego otherwise attractive investment opportunities or financing or hedging strategies.***

To qualify as a REIT for U.S. federal income tax purposes, we must continually satisfy various tests regarding the sources of our income, the nature and diversification of our assets, and the amounts we distribute to our shareholders. To meet these tests, we may be required to forego investments we might otherwise make. We may be required to make distributions to shareholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with the REIT requirements may hinder our investment performance.

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

To qualify as a REIT, we generally must ensure that at the end of each calendar quarter at least 75% of the value of our total assets consists of cash, cash items, government securities and qualifying real estate assets, including certain mortgage loans and MBS. The remainder of our investment in securities (other than government securities, securities of our TRSs and qualifying real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets can consist of the securities of any one issuer (other than government securities, securities of our TRSs and qualifying real estate assets), and no more than 25% of the value of our total securities can be represented by securities of one or more TRSs. If we fail to comply with these requirements at the end of any quarter, we must correct the failure within 30 days after the end of such calendar quarter or qualify for certain statutory relief provisions to avoid losing our REIT qualification and suffering adverse tax consequences. As a result, we may be required to liquidate from our portfolio otherwise attractive investments. These actions could have the effect of reducing our income and amounts available for distribution to our shareholders.

***REIT distribution requirements could adversely affect our ability to execute our business plan and may require us to incur debt, sell assets or take other actions to make such distributions.***

To qualify as a REIT, we must distribute to our shareholders each calendar year at least 90% of our REIT taxable income (including certain items of non-cash income), determined without regard to the deduction for dividends paid and excluding net capital gain. To the extent that we satisfy the 90% distribution requirement, but distribute less than 100% of our taxable income, we will be subject to U.S. federal corporate income tax on our undistributed income. In addition, we will incur a 4% nondeductible excise tax on the amount, if any, by which our distributions in any calendar year are less than a minimum amount specified under U.S. federal income tax laws. We intend to make sufficient distributions to our shareholders to satisfy the 90% distribution requirement and to avoid both corporate income tax and the 4% nondeductible excise tax.

Differences in timing between the recognition of taxable income and the actual receipt of cash may occur. For example, we may invest in assets, including debt instruments requiring us to accrue original issue discount (OID) or recognize market discount income that generate taxable income in excess of economic income or in advance of the corresponding cash flow from the assets, referred to as phantom income. We may also acquire distressed debt investments that are subsequently modified by agreement with the borrower either directly or pursuant to our involvement in programs recently announced by the federal government. If amendments to the outstanding debt are significant modifications under applicable Treasury Regulations, the modified debt may be considered to have been reissued to us in a debt-for-debt exchange with the borrower, with gain recognized by us to the extent that the principal amount of the modified debt exceeds our cost of purchasing it prior to modification. Finally, we may be required under the terms of the indebtedness that we incur, whether to private lenders or



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pursuant to government programs, to use cash received from interest payments to make principal payment on that indebtedness, with the effect that we will recognize income but will not have a corresponding amount of cash available for distribution to our shareholders.

As a result of the foregoing, we may find it difficult or impossible to meet the REIT distribution requirements in certain circumstances. In such circumstances, we may be required to (1) sell assets in adverse market conditions, (2) borrow on unfavorable terms, (3) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures or repayment of debt, or (4) make a taxable distribution of our shares of common stock as part of a distribution in which shareholders may elect to receive shares of common stock or (subject to a limit measured as a percentage of the total distribution) cash, in order to comply with the REIT distribution requirements. Thus, compliance with the REIT distribution requirements may hinder our ability to grow, which could adversely affect the value of our common stock.

***We may choose to pay dividends in our own stock, in which case our shareholders may be required to pay income taxes in excess of the cash dividends received.***

We may distribute taxable dividends that are payable in cash and in shares of our common stock at the election of each shareholder. Taxable shareholders receiving such dividends will be required to include the full amount of the dividend as ordinary income to the extent of our current and accumulated earnings and profits for federal income tax purposes. As a result, a U.S. shareholder may be required to pay income taxes with respect to such dividends in excess of the cash dividends received. If a U.S. shareholder sells the stock it receives as a dividend in order to pay this tax, the sales proceeds may be less than the amount included in income with respect to the dividend, depending on the market price of our stock at the time of the sale. Furthermore, with respect to non-U.S. shareholders, we may be required to withhold U.S. tax with respect to such dividends, including in respect of all or a portion of such dividend that is payable in stock. In addition, if a significant number of our shareholders determine to sell shares of our common stock in order to pay taxes owed on dividends, it may put downward pressure on the trading price of our common stock.

***Our ownership of and relationship with any TRS which we may form or acquire will be limited, and a failure to comply with the limits would jeopardize our REIT qualification and may result in the application of a 100% excise tax.***

A REIT may own up to 100% of the stock of one or more TRSs. A TRS may earn income that would not be qualifying income if earned directly by the parent REIT. Both the subsidiary and the REIT must jointly elect to treat the subsidiary as a TRS. Overall, no more than 25% of the value of a REIT's assets may consist of stock or securities of one or more TRSs at the end of any calendar quarter. A TRS will pay federal, state and local income tax at regular corporate rates on any income that it earns. In addition, the TRS rules impose a 100% excise tax on certain transactions between a TRS and its parent REIT that are not conducted on an arm's length basis.

Any TRS that we may form would pay U.S. federal, state and local income tax on its taxable income, and its after-tax net income would be available for distribution to us but would not be required to be distributed to us. We will monitor the value of our investments in our TRSs to ensure compliance with the rule that no more than 25% of the value of our assets may consist of TRS stock and securities. In addition, we will scrutinize all of our transactions with TRSs to ensure that they are entered into on arm's length terms to avoid incurring the 100% excise tax described above. There can be no assurance, however, that we will be able to comply with the TRS limitations or to avoid application of the 100% excise tax discussed above.

***Liquidation of our assets may jeopardize our REIT qualification.***

To qualify as a REIT, we must comply with requirements regarding our assets and our sources of income. If we are compelled to liquidate our investments to repay obligations to our lenders, we may be unable to comply with these requirements, ultimately jeopardizing our qualification as a REIT.

***Characterization of the repurchase agreements we enter into to finance our investments as sales for tax purposes rather than as secured borrowing transactions, or the failure of a mezzanine loan to qualify as a real estate asset would adversely affect our ability to qualify as a REIT.***

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We may enter into repurchase agreements with a variety of counterparties to achieve our desired amount of leverage for the assets in which we invest. When we enter into a repurchase agreement, we generally sell assets to our counterparty to the agreement and receive cash from the counterparty. The counterparty is obligated to resell the assets back to us at the end of the term of the transaction. We believe that, for U.S. federal income tax purposes, we will be treated as the owner of the assets that are the subject of repurchase agreements and that the repurchase agreements will be treated as secured borrowing transactions notwithstanding that such agreements may transfer record ownership of the assets to the counterparty during the term of the agreement. It is possible, however, that the IRS could successfully assert that we did not own these assets during the term of the repurchase agreements, in which case we could fail to qualify as a REIT.

In addition, we may acquire mezzanine loans, which are loans secured by equity interests in a partnership or limited liability company that directly or indirectly owns real property. In Revenue Procedure 2003-65, the IRS provided a safe harbor pursuant to which a mezzanine loan, if it meets each of the requirements contained in the Revenue Procedure, will be treated by the IRS as a real estate asset for purposes of the REIT asset tests, and interest derived from the mezzanine loan will be treated as qualifying mortgage interest for purposes of the 75% gross income test. Although the Revenue Procedure provides a safe harbor on which taxpayers may rely, it does not prescribe rules of substantive tax law. We may acquire mezzanine loans that may not meet all of the requirements for reliance on this safe harbor. In the event we own a mezzanine loan that does not meet the safe harbor, the IRS could challenge such loan's treatment as a real estate asset for purposes of the REIT asset and income tests, and if such a challenge were sustained, we could fail to qualify as a REIT.

***The taxable mortgage pool rules may limit our financing options.***

Securitizations and certain other financing structures could result in the creation of taxable mortgage pools for federal income tax purposes. A taxable mortgage pool owned by our Operating Partnership would be treated as a corporation for U.S. federal income tax purposes and may cause us to fail the REIT asset tests. These rules may limit our financing options.

***The tax on prohibited transactions will limit our ability to engage in transactions, including certain methods of securitizing mortgage loans, which would be treated as sales for federal income tax purposes.***

A REIT's net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property, but including mortgage loans, held primarily for sale to customers in the ordinary course of business. We might be subject to this tax if we were to dispose of or securitize loans in a manner that was treated as a sale of the loans for federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose not to engage in certain sales of loans at the REIT level and may limit the structures we utilize for our securitization transactions, even though the sales or structures might otherwise be beneficial to us.

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

The REIT provisions of the Internal Revenue Code limit our ability to enter into hedging transactions. In order to qualify as a REIT, we must satisfy two gross income tests annually. For these purposes, income with respect to certain hedges of our liabilities or foreign currency risks will be disregarded. Income from other hedges will be non-qualifying income for purposes of both gross income tests. As a result, we might have to limit our use of advantageous hedging techniques or implement those hedges through a TRS, which we may form. This could increase the cost of our hedging activities or expose us to greater risks associated with changes in interest rates than we would otherwise want to bear.

***Even if we qualify as a REIT, we may face tax liabilities that reduce our cash flow.***

Even if we qualify as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, and state or local income, franchise, property and transfer taxes, including mortgage-related taxes. In addition, any TRSs we own will be subject to U.S. federal, state, and local corporate taxes. In order to meet the

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REIT qualification requirements, or to avoid the imposition of a 100% prohibited transaction tax that applies to certain gains derived by a REIT from sales of inventory or property held primarily for sale to customers in the ordinary course of business, we may hold some of our assets through TRSs. Any taxes paid by such TRSs would decrease the cash available for distribution to our shareholders.

*We may be subject to adverse legislative or regulatory tax changes that could reduce the market price of our common stock.*

At any time, the U.S. federal income tax laws or regulations governing REITs or the administrative interpretations of those laws or regulations may be amended. We cannot predict when or if any new U.S. federal income tax law, regulation or administrative interpretation, or any amendment to any existing federal income tax law, regulation or administrative interpretation, will be adopted, promulgated or become effective. Any such law, regulation or interpretation may take effect retroactively. We and our shareholders could be adversely affected by any such change in, or any new, federal income tax law, regulation or administrative interpretation.

*Dividends paid by REITs do not qualify for the reduced tax rates that apply to other corporate dividends.*

The maximum tax rate for qualified dividends paid by corporations to individuals is 15% through 2012. Dividends paid by REITs, however, generally continue to be taxed at the normal ordinary income rate applicable to the individual recipient (subject to a maximum rate of 35% through 2012), rather than the 15% preferential rate. The more favorable rates applicable to regular corporate dividends could cause potential investors who are individuals to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay qualified dividends, which could adversely affect the value of the stock of REITs, including our common stock.

*We may be affected by deficiencies in foreclosure practices of third parties, as well as related delays in the foreclosure process.*

Recent announcements of deficiencies in foreclosure documentation by, among others, several large mortgage servicers have raised various concerns relating to foreclosure practices. A number of mortgage servicers have temporarily suspended foreclosure proceedings in some or all states in which they do business while they review and correct their foreclosure practices. In addition, a group consisting of state attorneys general and state bank and mortgage regulators in all 50 states and the District of Columbia has announced it is reviewing foreclosure practices in their various jurisdictions. The extension of foreclosure timelines increases the inventory backlog of distressed homes on the market and creates greater uncertainty about housing prices. Prior to making investments in non-Agency RMBS, we carefully consider many factors, including housing prices and foreclosure timelines, and estimate loss assumptions. The concerns about deficiencies in foreclosure practices of servicers and related delays in the foreclosure process may impact our loss assumptions and affect the values of, and our returns on, our investments in non-Agency RMBS. Our management is actively reviewing and monitoring the deficiencies and delays in the foreclosure process and assessing its potential impact on our business, financial condition, and results of operations.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

Our principal executive office is located at 1555 Peachtree Street, NE, Atlanta, Georgia 30309. As part of our management agreement, our Manager is responsible for providing office space and office services required in rendering services to us.

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**Item 3. Legal Proceedings.**

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of December 31, 2011, we were not involved in any such legal proceedings.

**Item 4. Mine and Safety Disclosures**

Not applicable.

**Table of Contents****Index to Financial Statements****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.****Market Information**

Our common stock is traded on the NYSE under the symbol IVR. The following table sets forth, for the periods indicated, the high and low sale price of our common stock as reported on the NYSE.

|                    | <b>High</b> | <b>Low</b> |
|--------------------|-------------|------------|
| <b><u>2011</u></b> |             |            |
| Fourth quarter     | \$16.23     | \$12.55    |
| Third quarter      | \$22.13     | \$14.10    |
| Second quarter     | \$23.30     | \$20.53    |
| First quarter      | \$24.07     | \$21.14    |
| <b><u>2010</u></b> |             |            |
| Fourth quarter     | \$23.60     | \$20.83    |
| Third quarter      | \$23.20     | \$19.25    |
| Second quarter     | \$23.48     | \$15.00    |
| First quarter      | \$23.99     | \$21.35    |

 **Holders**

As of February 29, 2012, there were 66 shareholders of record.

**Dividends**

U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates on its undistributed taxable income. We intend to continue to pay regular quarterly dividends to our shareholders in an amount equal to our net taxable income. 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 debt 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.

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The following table sets forth the dividends declared per share of our common stock.

| Date Declared      | Dividends Declared Per Share |                  |
|--------------------|------------------------------|------------------|
|                    | Amount                       | Date of Payment  |
| <b><u>2011</u></b> |                              |                  |
| December 8, 2011   | \$0.65                       | January 27, 2012 |
| September 8, 2011  | \$0.80                       | October 27, 2011 |
| June 9, 2011       | \$0.97                       | July 28, 2011    |
| March 14, 2011     | \$1.00                       | April 27, 2011   |
| <b><u>2010</u></b> |                              |                  |
| December 14, 2010  | \$0.97                       | January 27, 2011 |
| September 20, 2010 | \$1.00                       | October 27, 2010 |
| June 21, 2010      | \$0.74                       | July 27, 2010    |
| March 17, 2010     | \$0.78                       | April 22, 2010   |

**Performance Graph**

The following graph matches the cumulative 18-month total return of holders of Invesco Mortgage Capital Inc.'s common stock with the cumulative total returns of the S&P 500 index and the FTSE NAREIT Mortgage REITs index. The graph assumes that the value of the investment in our common stock and in each of the indices (including reinvestment of dividends) was \$100 on June 30, 2009 and tracks it through December 31, 2011.

|                               | 6/30/2009 | 12/31/2009 | 6/30/2010 | 12/31/2010 | 6/30/2011 | 12/31/2011 |
|-------------------------------|-----------|------------|-----------|------------|-----------|------------|
| <b>Index</b>                  |           |            |           |            |           |            |
| Invesco Mortgage Capital Inc. | 100.00    | 125.82     | 118.58    | 141.39     | 149.56    | 109.05     |
| S&P 500                       | 100.00    | 122.59     | 114.43    | 141.05     | 149.55    | 144.03     |
| FTSE NAREIT Mortgage REITs    | 100.00    | 118.98     | 123.50    | 145.86     | 151.89    | 142.34     |

The stock price performance included in this graph is not necessarily indicative of future stock price performance.

**Table of Contents****Index to Financial Statements****Use of Proceeds**

We used all of the net proceeds from the IPO, private placement and subsequent follow-on offerings, to acquire our target assets in accordance with our objectives and strategies described above. See **Business Investment Strategy**. Our focus is on purchasing Agency RMBS, non-Agency RMBS, CMBS and certain residential and commercial mortgage loans, subject to our investment guidelines and to the extent consistent with maintaining our REIT qualification. Our Manager will make determinations as to the percentage of our equity that will be invested in each of our target assets.

**Issuer Purchases of Equity Securities**

On December 13, 2011, we announced a share repurchase program that was approved by our Board of Directors for up to 7 million shares of our common stock. The shares may be repurchased from time to time through privately negotiated transactions or open market transactions, including pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under Exchange Act or by any combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors, including market conditions and applicable SEC rules. As of December 31, 2011, we have not repurchased any shares under this program.

**Item 6. Selected Financial Data.**

The selected historical financial information as of and for the year ended December 31, 2011, December 31, 2010 and December 31, 2009 presented in the tables below have been derived from our audited financial statements. The information presented below is not necessarily indicative of the trends in our performance.

The information presented below is only a summary and does not provide all of the information contained in our historical financial statements, including the related notes. You should read the information below in conjunction with **Management's Discussion and Analysis of Financial Condition and Results of Operations** and our historical financial statements, including the related notes, included elsewhere in this Report.

**Balance Sheet Data**

|   | <b>As of December 31,</b> |             |             |             |
|---|---------------------------|-------------|-------------|-------------|
| <b>\$ in thousands</b>                    | <b>2011</b>               | <b>2010</b> | <b>2009</b> | <b>2008</b> |
| Mortgage-backed securities, at fair value | 14,214,149                | 5,578,333   | 802,592     | -           |
| Total assets                              | 14,772,167                | 5,862,399   | 853,400     | 979         |
| Repurchase agreements                     | 12,253,038                | 4,344,659   | 545,975     | -           |
| TALF financing                            | -                         | -           | 80,377      | -           |
| Total shareholders' equity                | 1,892,337                 | 1,019,151   | 180,515     | (21)        |
| Non-controlling interest                  | 25,075                    | 31,664      | 29,795      | -           |
| Total equity                              | 1,917,413                 | 1,050,814   | 210,310     | (21)        |

**Table of Contents****Index to Financial Statements****Statement of Operations Data**

|  | For the Years ended December 31, |                |               | Period from June 5,<br>2008 (Date of<br>Inception) to<br>December 31, 2008 |
|--|----------------------------------|----------------|---------------|--|
|  | 2011                             | 2010           | 2009          |  |
| <b>\$ in thousands, except per share data</b>                  |                                  |                |               |  |
| Interest income  | 453,352                          | 134,229        | 23,529        | -  |
| Interest expense   | 155,241                          | 29,556         | 4,627         | -  |
| <b>Net interest income</b>                                     | <b>298,111</b>                   | <b>104,673</b> | <b>18,902</b> | <b>-</b>   |
| Other income   | 18,804                           | 11,145         | 2,073         | -  |
| Operating expenses   | 30,118                           | 12,093         | 3,464         | 22   |
| <b>Net income</b>  | <b>286,797</b>                   | <b>103,725</b> | <b>17,511</b> | <b>(22)</b>  |
| Net income attributable to non-controlling interest            | 4,882                            | 5,326          | 2,417         | -  |
| Net income attributable to common shareholders                 | 281,915                          | 98,399         | 15,094        | (22)   |
| <b>Earnings per share:</b>                                     |                                  |                |               |  |
| Net income attributable to common shareholders (basic/diluted) | 3.27                             | 3.78           | 3.37          | -  |
| Dividends declared per common share                            | 3.42                             | 3.49           | 1.66          | -  |
| <b>Weighted average number of shares of common stock:</b>      |                                  |                |               |  |
| Basic  | 86,365                           | 26,039         | 4,480         | NM   |
| Diluted  | 87,804                           | 27,468         | 5,198         | NM   |

NM = not meaningful

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

The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes to our consolidated financial statements, which are included in this Report.

**Overview**

We are a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. We are externally managed and advised by Invesco Advisers, Inc., our Manager, which is an indirect, wholly-owned subsidiary of Invesco Ltd. We elected to qualify to be taxed as a REIT commencing with our taxable year ended December 31, 2009. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income that we distribute currently to our shareholders as long as we maintain our qualification as a REIT. We operate our business in a manner that will permit us to maintain our exclusion from the definition of investment company under the Investment Company Act of 1940, as amended (the "1940 Act").

Our objective is to provide attractive risk-adjusted returns to our shareholders, primarily through dividends and secondarily through capital appreciation. To achieve this objective, we primarily invest in the following:



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Agency RMBS, which are residential mortgage-backed securities, for which a U.S. government Agency such as the Government National Mortgage Association ( Ginnie Mae ) or a federally chartered corporation such as the Federal National Mortgage Association ( Fannie Mae ) or the Federal Home Loan Mortgage Corporation ( Freddie Mac ) guarantees payments of principal and interest on the securities;

Non-Agency RMBS, which are RMBS that are not issued or guaranteed by a U.S. government agency or a federally chartered corporation;

CMBS, which are commercial mortgage-backed securities; and

Residential and commercial mortgage loans.

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We finance our investments in Agency RMBS, non-Agency RMBS and CMBS through short-term borrowings structured as repurchase agreements. We have also financed our investments in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing capital to the Invesco IMRF Fund that received financing under the U.S. government's PIPP, established and managed by our Manager or one of its affiliates, which, in turn, invests in our target assets.

**Public Offerings**

During 2011, the Company completed three follow-on common stock offerings and issued 61.4 million shares of common stock with net proceeds of approximately \$1.2 billion. In addition, the Company issued 4.1 million shares of common stock under the share repurchase feature of the Company's Dividend Reinvestment and Share Purchase Plan (DRSPP) with net proceeds of approximate \$85.8 million. The investment of the proceeds from these offerings and the related increase in borrowings under our repurchase agreements increased our investment portfolio and was the primary driver for the changes in our results of operations.

**Factors Impacting Our Operating Results**

Our operating results can be affected by a number of factors and primarily depend on, among other things, the level of our net interest income, the market value of our assets and the supply of, and demand for, the target assets in which we invest. Our net interest income, which includes the amortization of purchase premiums and accretion of purchase discounts, varies primarily as a result of changes in market interest rates and prepayment speeds, as measured by the constant prepayment rate (CPR) on our target assets. Interest rates and prepayment speeds vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty.

**Market Conditions**

Beginning in the summer of 2007, significant adverse changes in financial market conditions resulted in a deleveraging of the entire global financial system. As part of this process, residential and commercial mortgage markets in the United States experienced a variety of difficulties, including loan defaults, credit losses and reduced liquidity. As a result, many lenders tightened their lending standards, reduced lending capacity, liquidated significant portfolios or exited the market altogether, and therefore, financing with attractive terms was generally unavailable. In response to these unprecedented events, the U.S. government has taken a number of actions to stabilize the financial markets and encourage lending. Significant measures include the enactment of the Emergency Economic Stabilization Act of 2008 to, among other things, establish the Troubled Asset Relief Program (TARP), the enactment of the Housing and Economic Recovery Act of 2008 (HERA), which established a new regulator for Fannie Mae and Freddie Mac and the establishment of the TALF and the PPIP. Some of these programs are beginning to expire and the impact of the wind-down of these programs on the financial sector and on the economic recovery is unknown. Increased volatility in the RMBS markets may have an adverse effect on the market value and performance of the RMBS in which we invest. Moreover, we rely on financing to acquire, on a leveraged basis, the target assets in which we invest. If market conditions deteriorate further, our lenders may exit the repurchase market, further 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.

The Dodd-Frank Act enacted on July 21, 2010, contains numerous provisions affecting the financial and mortgage industries, many of which may have an impact on our operating environment and the target assets in which we invest. Consequently, the Dodd-Frank Act may affect our cost of doing business, may limit our investment opportunities and may affect the competitive balance within our industry and market areas.

On September 21, 2011, the U.S. Federal Reserve announced Operation Twist, which is a program by which it intends to purchase, by the end of June 2012, \$400 billion of U.S. Treasury securities with remaining maturities between 6 and 30 years and sell an equal amount of U.S. Treasury securities with remaining maturities of 3 years or less. Operation Twist could result in a flattening in the yield curve and lower long-term interest rates. Lower long-term interest rates could result in increased prepayment rates and a narrowing of our net interest margin. Consequently, Operation Twist and any other future securities purchase programs and actions by the U.S. Federal Reserve could adversely affect our business, financial condition and results of operations and our ability to pay distributions to our shareholders.

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The Federal Housing Finance Agency ( FHFA ) and the Department of the Treasury introduced the Home Affordable Refinance Program ( HARP ) in early 2009. HARP provides borrowers, who may not otherwise qualify for refinancing because of declining home values or reduced access to mortgage insurance, the ability to refinance their mortgages into a lower interest rate and/or more stable mortgage product. On October 24, 2011, the FHFA announced a series of changes to the rules regarding the HARP with intent of increasing the number of borrowers eligible to refinance their mortgage under this program. The FHFA announced changes to the guidelines related to loan-to-value, appraisals, and certain fees, among other things, subject to a variety of qualifications and the extension of the end date for the HARP until December 31, 2013. It does not change the time period which these loans were originated, maintaining the requirement that the loans must have been guaranteed by Fannie Mae or Freddie Mac on or before May 31, 2009. We do not expect the current HARP or future modifications to have a material impact on our results of operations in future periods.

On January 25, 2012, the U.S. Federal Reserve announced that it would keep the target range for the federal funds rate at 0 to 1/4 percent and that it currently anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014. Low levels of federal funds rates may reduce our borrowing costs. However, there can be no assurance that federal funds rates will remain near 0 percent, or that such low levels will reduce our cost of funds.

**Investment Activities**

As of December 31, 2011, 55.1% (2010: 48.2%) of our equity was invested in Agency RMBS, 24.5% (2010: 37.1%) in non-Agency RMBS, 16.8% (2010: 9.4%) in CMBS, and 3.6% (2010: 5.3%) in the Invesco IMRF Fund. We continually evaluate market opportunities of each of our asset classes and adjust equity allocations based on our risk and return targets. We use leverage on our target assets to achieve our return objectives. For our total investment portfolio, we focus on securities we believe provide attractive returns when levered approximately 3 to 7 times. The leverage may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense, while maintaining our overall portfolio leverage guidelines.

As of December 31, 2011, we had approximately \$6.6 billion (2010: \$2.2 billion) in 30-year fixed rate securities that offered higher coupons and call protection based on the collateral attributes. We balanced this with approximately \$2.4 billion (2010: \$1.9 billion) in 15-year fixed rate, approximately \$1.4 billion (2010: \$72.3 million) in hybrid adjustable-rate mortgages ( ARMs ) and approximately \$117.9 million (2010: \$22.5 million) in ARMs we believe to have similar durations based on prepayment speeds. As of December 31, 2011, we had purchased approximately \$2.4 billion (2010: \$846.4 million) non-Agency RMBS.

As of December 31, 2011, we owned approximately \$1.2 billion (2010: \$497.9 million) in CMBS financed with \$844.9 million (2010: \$401.2 million) in repurchase agreements. In addition, as of December 31, 2011, we had purchased approximately \$168.5 million (2010: \$28.8 million) in CMOs.

**Portfolio Characteristics**

The table below represents the vintage of the credit assets as of December 31, 2011.

|                  | 2003 | 2004 | 2005  | 2006  | 2007  | 2008 | 2009 | 2010  | 2011  | Total  |
|------------------|------|------|-------|-------|-------|------|------|-------|-------|--------|
| Re-REMIC Senior  | -    | -    | -     | -     | -     | -    | -    | 6.9%  | 62.4% | 69.3%  |
| Prime            | 1.1% | 1.2% | 1.9%  | 3.1%  | 12.2% | -    | -    | -     | 0.9%  | 20.4%  |
| Alt-A            | -    | -    | 1.3%  | 3.4%  | 5.1%  | -    | -    | -     | -     | 9.8%   |
| Subprime         | -    | 0.5% | -     | -     | -     | -    | -    | -     | -     | 0.5%   |
| Total Non-Agency | 1.1% | 1.7% | 3.2%  | 6.5%  | 17.3% | -    | -    | 6.9%  | 63.3% | 100.0% |
| CMBS             | -    | -    | 22.4% | 21.9% | -     | -    | -    | 15.7% | 40.0% | 100.0% |



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The tables below represent the geographic concentration as of December 31, 2011:

| <b>Non-Agency RMBS<br/>State</b> | <b>Percentage</b> | <b>CMBS<br/>State</b> | <b>Percentage</b> |
|----------------------------------|-------------------|-----------------------|-------------------|
| California                       | 50.0%             | California            | 15.2%             |
| Florida                          | 8.0%              | New York              | 12.5%             |
| New York                         | 5.6%              | Texas                 | 10.3%             |
| Virginia                         | 3.2%              | Florida               | 5.9%              |
| New Jersey                       | 2.9%              | Illinois              | 4.5%              |
| Washington                       | 2.9%              | Pennsylvania          | 4.0%              |
| Arizona                          | 2.8%              | New Jersey            | 3.6%              |
| Maryland                         | 2.8%              | Maryland              | 3.3%              |
| Illinois                         | 2.2%              | Ohio                  | 3.2%              |
| Colorado                         | 2.0%              | Virginia              | 3.0%              |
| Other                            | 17.6%             | Other                 | 34.5%             |

The vintage and geographic concentrations have not significantly changed since September 30, 2011.

*Financing and Other Liabilities*

We enter into repurchase agreements to finance the majority of our Agency RMBS, non-Agency RMBS and CMBS. These agreements are secured by our Agency RMBS, non-Agency RMBS and CMBS and bear interest at rates that have historically moved in close relationship to the London Interbank Offer Rate ( LIBOR ). As of December 31, 2011, we had entered into repurchase agreements totalling \$12.3 billion (2010: \$4.3 billion). The increase in borrowings was the result of the additional assets added after our follow-on common stock offerings and the change in our portfolio composition. We also committed to invest up to \$100.0 million in the Invesco IMRF Fund, which, in turn, invests in our target assets. As of December 31, 2011, approximately \$79.7 million (2010: \$61.0 million) of our commitment to the Invesco IMRF Fund has been called.

The Company records the liability for mortgage-backed securities purchased for which settlement has not taken place as an investment related payable. As of December 31, 2011 and 2010, the Company had investment related payables of \$107.0 million and \$372.3 million, respectively, of which no items were outstanding greater than thirty days. The change in the balance was primarily due to a decrease in unsettled mortgage-backed securities purchased at the end of 2011 compared to 2010, as a result of a follow-on common stock offering which closed on December 20, 2010.

*Hedging Instruments*

We generally hedge as much of our interest rate risk as we deem prudent in light of market conditions. No assurance can be given that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Our investment policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge.

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

available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;

the duration of the hedge may not match the duration of the related liability;

the party owing money in the hedging transaction may default on its obligation to pay;



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the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and

the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments or mark-to-market losses reduce our shareholders' equity.

As of December 31, 2011, we have entered into interest rate swap agreements designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swap agreements provide for fixed interest rates indexed off of one-month LIBOR and effectively fix the floating interest rates on \$6.9 billion (2010: \$2.6 billion) of borrowings under our repurchase agreements as of December 31, 2011. The increase in the notional amount of interest rate swaps was due to the increase in borrowings after our follow-on common stock offerings. As of December 31, 2011, all of our interest rate swaps are effective and the average maturity is 4.4 years compared to 5.3 years at December 31, 2010. We continue to adjust our interest rate hedge positions according to our hedging strategy and changing market conditions.

**Book Value per Share**

Our book value was \$16.41 and \$20.49 as of December 31, 2011 and 2010, respectively, on a fully diluted basis, after giving effect to our units of limited partnership interest in our Operating Partnership, which may be converted to common shares at the sole election of the Company. The decline in our book value was primarily due to the change in valuation of our investment portfolio and our interest rate hedges that are recorded in Other Comprehensive Income (Loss) on our balance sheet. The value of our assets and liabilities change daily based on market conditions. Refer to Item 7A. Quantitative and Qualitative Disclosures About Market Risks for interest rate risk and its impact on fair value.

**Critical Accounting Policies**

Our consolidated financial statements are prepared in accordance with US GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. Our most critical accounting policies involve decisions and assessments that could affect our reported assets, liabilities, revenues and expenses. We believe that all of the decisions and assessments upon which our consolidated financial statements were based were reasonable at the time made and based upon information available to us at that time. We rely upon independent pricing of our assets at each quarter's end to arrive at what we believe to be reasonable estimates of fair market value. For a discussion of our critical accounting policies, see Notes to Consolidated Financial Statements in the financial statements accompanying this Report.

**Expected Impact of New Authoritative Guidance on Future Financial Information**

In April 2011, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update 2011-03, Reconsideration of Effective Control for Repurchase Agreements (ASU 2011-03). ASU 2011-03 simplifies the accounting for financial assets transferred under repurchase agreements and similar arrangements, by eliminating the transferor's ability criterion from the assessment of effective control over those assets. The guidance is effective for fiscal years and interim periods beginning after December 15, 2011. We do not believe that the adoption of the amended guidance will have a significant effect on our consolidated financial statements now or in the future.

In May 2011, the FASB issued Accounting Standards Update 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS (ASU 2011-04). ASU 2011-04 amends Topic 820 and does not modify the requirements for when fair value measurements apply; rather, it clarifies the Board's intent about the application of existing fair value measurement requirements, and changes to a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. For public entities, this guidance is effective for fiscal years and interim periods beginning after December 15, 2011. Early application by public entities is not permitted. We do not anticipate any material impact from this guidance now or in the future.

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In December 2011, the FASB issued Accounting Standards Updated 2011-11, Disclosures about Offsetting Assets and Liabilities (ASU 2011-11). ASU 2011-11 amends Topic 210 to require additional disclosure information about offsetting and related arrangements. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of US GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards (IFRS). The guidance is effective for periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company does not anticipate any material impact from this guidance.

**Results of Operations**

The table below presents certain information from our Consolidated Statement of Operations for the years ended December 31, 2011, 2010 and 2009.

|  | <b>Years Ended December 31,</b> |                |               |
|--|---------------------------------|----------------|---------------|
|  | <b>2011</b>                     | <b>2010</b>    | <b>2009</b>   |
| <b>\$ in thousands, except per share data</b>                  |                                 |                |               |
| <b>Revenues</b>  |                                 |                |               |
| Interest income  | 453,352                         | 134,229        | 23,529        |
| Interest expense   | 155,241                         | 29,556         | 4,627         |
| <b>Net interest income</b>                                     | <b>298,111</b>                  | <b>104,673</b> | <b>18,902</b> |
| <b>Other income</b>  | <b>18,804</b>                   | <b>11,145</b>  | <b>2,073</b>  |
| <b>Expenses</b>  |                                 |                |               |
| Management fee – related party                                 | 26,259                          | 8,080          | 1,513         |
| General and administrative                                     | 3,859                           | 4,013          | 1,951         |
| <b>Total expenses</b>  | <b>30,118</b>                   | <b>12,093</b>  | <b>3,464</b>  |
| Net income   | 286,797                         | 103,725        | 17,511        |
| Net income attributable to non-controlling interest            | 4,882                           | 5,326          | 2,417         |
| Net income attributable to common shareholders                 | 281,915                         | 98,399         | 15,094        |
| <b>Earnings per share:</b>                                     |                                 |                |               |
| Net income attributable to common shareholders (basic/diluted) | 3.27                            | 3.78           | 3.37          |
| Dividends declared per common share                            | 3.42                            | 3.49           | 1.66          |
| <b>Weighted average number of shares of common stock:</b>      |                                 |                |               |
| Basic  | 86,365                          | 26,039         | 4,480         |
| Diluted  | 87,804                          | 27,468         | 5,198         |





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The table below presents certain information for our portfolio as of and for the years ended December 31, 2011, 2010, and 2009.

**As of and for the Years Ended**

| <b>\$ in thousands</b>                             | <b>2011</b>       | <b>December 31,<br/>2010</b> | <b>2009</b>    |
|--|-------------------|------------------------------|----------------|
| <b>Average Balances*:</b>                          |                   |                              |                |
| Agency RMBS:                                       |                   |                              |                |
| 15 year fixed-rate, at fair value (Including CMOs) | 2,279,661         | 811,966                      | 301,127        |
| 30 year fixed-rate, at fair value                  | 4,603,117         | 874,214                      | 224,335        |
| ARM, at fair value                                 | 87,033            | 11,819                       | 10,279         |
| Hybrid ARM, at fair value                          | 1,009,829         | 83,878                       | 141,140        |
| Non-Agency RMBS, at fair value                     | 2,030,195         | 622,574                      | 108,935        |
| CMBS, at fair value                                | 988,105           | 262,182                      | 80,598         |
| <b>Average MBS portfolio</b>                       | <b>10,997,940</b> | <b>2,666,633</b>             | <b>866,414</b> |
| <b>Average Portfolio Yields (1):</b>               |                   |                              |                |
| Agency RMBS:                                       |                   |                              |                |
| 15 year fixed-rate, (Including CMOs)               | 2.96%             | 2.87%                        | 3.35%          |
| 30 year fixed-rate                                 | 3.54%             | 3.37%                        | 4.74%          |
| ARM  | 2.96%             | 2.48%                        | 2.14%          |
| Hybrid ARM   | 2.55%             | 0.93%                        | 3.33%          |
| Non-Agency RMBS                                    | 6.88%             | 10.94%                       | 15.63%         |
| CMBS   | 5.54%             | 4.68%                        | 5.36%          |
| <b>Average MBS portfolio</b>                       | <b>4.12%</b>      | <b>5.03%</b>                 | <b>5.43%</b>   |
| <b>Average Borrowings*:</b>                        |                   |                              |                |
| Agency RMBS  | 7,146,066         | 1,570,211                    | 565,615        |
| Non-Agency RMBS                                    | 1,536,245         | 339,209                      | -              |
| CMBS   | 791,212           | 194,505                      | 60,400         |
| <b>Total borrowed funds</b>                        | <b>9,473,523</b>  | <b>2,103,925</b>             | <b>626,015</b> |
| <b>Average Cost of Funds (2):</b>                  |                   |                              |                |
| Agency RMBS  | 0.27%             | 0.27%                        | 0.33%          |
| Non-Agency RMBS                                    | 1.47%             | 1.59%                        | 0.00%          |
| CMBS   | 1.35%             | 2.77%                        | 3.38%          |
| Unhedged cost of funds                             | 0.56%             | 0.71%                        | 0.63%          |
| Hedged cost of funds                               | 1.64%             | 1.40%                        | 1.47%          |
| <b>Average Equity (3):</b>                         | <b>1,625,794</b>  | <b>590,177</b>               | <b>212,743</b> |

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|   |       |       |       |
|---|-------|-------|-------|
| Average debt/equity ratio (average during period) | 5.83x | 3.56x | 2.94x |
| Debt/equity ratio (as of period end)              | 6.4x  | 4.1x  | 3.0x  |

\* Average amounts for each period are based on weighted month end balances, all percentages are annualized.

(1) Average portfolio yield for the period was calculated by dividing interest income, including amortization of premiums and discounts, by our average of the investment balance at fair value.

(2) Average cost of funds is calculated by dividing interest expense, by our average borrowings.

(3) Average equity is calculated based on a weighted balance basis.

### Net Income Summary

For the year ended December 31, 2011, our net income attributable to common shareholders was \$281.9 million (2010: \$98.4 million; 2009: \$15.1 million), or \$3.27 (2010: \$3.78; 2009: \$3.37) basic and diluted net income per average share available to common shareholders.

The increase to net income attributable to common shareholders for the year ended December 31, 2011 versus 2010 is primarily attributable to the growth in our average investment portfolio resulting from our follow-on common stock offerings during 2011 and 2010. Our average MBS portfolio increased approximately \$8.3 billion during 2011 over 2010. During 2011, we completed three follow-on common stock offerings raising approximately \$1.3 billion in equity.

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The increase to net income attributable to common shareholders for 2010 versus 2009 is primarily attributable to the growth in our average investment portfolio resulting from our follow-on common stock offerings during 2010 and 2009 and a full year of income earned on our investment portfolio in 2010 versus approximately six months of operations in 2009. Our average MBS portfolio increased approximately \$1.8 billion during 2010 over 2009. In 2010, we completed four follow-on common stock offerings raising approximately \$830.8 million in equity.

**Interest Income and Average Earning Asset Yield**

Our primary source of income is interest earned on our investment portfolio. During 2011, we had average earning assets of approximately \$11.0 billion (2010: \$2.7 billion ; 2009: \$866.4 million) and earned interest income of \$453.4 million (2010: \$134.2 million ; 2009: \$23.5 million). The yield on our average investment portfolio was 4.12% (2010: 5.03%; 2009: 5.43%).

The change in our average assets and the portfolio yield for 2011 versus 2010 was primarily the result of the increase in our investment portfolio in connection with adding leverage and utilizing proceeds from our follow-on common stock offerings during 2011 and a change in our portfolio composition as we have allocated a higher amount of equity to Agency RMBS at lower yields and higher leverage.

The change in our average assets and the portfolio yield for 2010 versus 2009 was primarily the result of the increase in our average investment portfolio after our follow-on common stock offerings during 2010 and a full year of income earned on our investment portfolio during 2010.

The CPR of our portfolio impacts the amount of premium and discount on the purchase of securities that is recognized into income. Our Agency and non-Agency RMBS had a weighted average CPR of 12.9 and 8.7 for the three months ended December 31, 2011 and September 30, 2011, respectively. The table below shows the three-month CPR for our RMBS compared to bonds with similar characteristics ( Cohorts ):

|                                | December 31, 2011 |        | September 30, 2011 |        |
|--------------------------------|-------------------|--------|--------------------|--------|
|                                | Company           | Cohort | Company            | Cohort |
| 15 year Agency RMBS            | 11.2              | 25.6   | 9.1                | 20.5   |
| 30 year Agency RMBS            | 12.1              | 20.6   | 9.8                | 16.2   |
| Agency Hybrid ARM RMBS         | 19.4              | NA     | 14.9               | N/A    |
| Non-Agency RMBS <sup>(1)</sup> | 14.8              | NA     | 8.1                | N/A    |
| Overall                        | 13.3              | NA     | 8.7                | N/A    |

- (1) For the three months ended December 31, 2011, the calculation of CPR for non-Agency RMBS has been modified to reflect voluntary prepayments and recoveries upon default and is adjusted for the effect of additional subordination on Re-REMIC Senior investments. If the same calculation were to be applied for the three months ended September 30, 2011, the non-Agency RMBS CPR would have been 17.7 and the overall CPR would have been 12.4.

**Interest Expense and the Cost of Funds**

Our largest expense is the interest expense on borrowed funds. For 2011, we had average borrowed funds of approximately \$9.5 billion (2010: \$2.1 billion; 2009: \$626.0 million) and total interest expense of \$155.2 million (2010: \$29.6 million; 2009: \$4.6 million).

The increase in average borrowed funds for 2011 versus 2010 was primarily the result of increasing our investment portfolio leverage in connection with our follow-on common stock offerings. The increase in interest expense for 2011 versus 2010 was primarily the result of a higher average borrowing balance outstanding and higher average cost of funds.

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The increase in average borrowed funds for 2010 versus 2009 was primarily the result of increasing our investment portfolio leverage in connection with our follow-on common stock offerings and higher average borrowing balance outstanding for a full year in 2010 versus approximately six months in 2009.

For the year ended December 31, 2011, our average hedged cost of funds was 1.64% (2010: 1.40%; 2009: 1.47%). Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. Interest expense includes borrowing costs under repurchase agreements as well as costs for our interest rate hedges.

**Net Interest Income**

Our net interest income, which equals interest income less interest expense for the year ended December 31, 2011, totaled \$298.1 million (2010: \$104.7 million; 2009: \$18.9 million). Our net interest rate margin for the year ended December 31, 2011, which equals the yield on our average assets for the period less the average cost of funds for the period, was 2.48% (2010: 3.63%; 2009: 3.96%). The increase in net interest income was primarily the result of increasing our investment portfolio with our follow-on common stock offerings. The decrease in net interest margin was primarily due to higher hedged cost of funds related to the increase in average borrowings and interest rate swaps. In addition, since our initial public offering was completed in June 2009, 2010 contained a full year of earnings compared to 2009.

**Gain on Sale of Investments**

As part of our ongoing credit evaluation process, all of our MBS are reviewed on a monthly basis to determine if they continue to meet our risk and return targets. This process involves looking at changing market assumptions and the impact those assumptions will have on the individual securities. As a result of our change in market assumptions, we sold securities and recognized a net gain of approximately \$11.0 million for the year ended December 31, 2011 (2010: \$3.5 million; 2009: \$2.0 million).

**Loss on Other-Than-Temporary Impaired Securities**

For the year ended December 31, 2011, we recognized no losses (2010: \$510,000; 2009: \$0) on other-than-temporarily impaired securities in the consolidated statement of operations which had been included in accumulated other comprehensive income. Credit losses recognized during 2010 on non-Agency RMBS were anticipated and included in the price paid for the asset at acquisition and were included in the security's estimated yield at acquisition.

**Equity in Earnings and Change in Fair Value of Unconsolidated Ventures**

For the year ended December 31, 2011, we recognized equity in earnings and unrealized loss on the change in fair value of our investment in the Invesco IMRF Fund of approximately \$6.0 million (2010: \$4.8 million; 2009: \$63,000) and \$3.8 million (2010: unrealized appreciation of \$3.5 million; 2009: unrealized appreciation of \$8,000), respectively. The increase in equity in earnings and decrease in unrealized income on the change in fair value was primarily the result of realizing gains on investments sold during 2011 and a decrease in the fair value of investments remaining in the Invesco IMRF Fund at December 31, 2011.

We invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC ( IMRF ). For the year ended December 31, 2011, we recognized equity in earnings and unrealized appreciation on the change in fair value of our investment in the IMRF of approximately \$759,000 and \$325,000, respectively.

**Credit Default Swap**

On December 30, 2010, we entered into a credit default swap ( CDS ) contract. For the year ended December 31, 2011 we recognized income of \$5.3 million (2010: \$13,000) on our investment in the CDS of which \$1.3 million (2010: \$0) is an unrealized gain based on change in the fair market value of the CDS and \$4.0 million (2010: \$13,000) represents premium payments we receive for providing protection.

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**Other Income (Loss)**

The Company finances its activities primarily through repurchase agreements, which are generally settled on a short-term basis, usually from one to twelve months. At each settlement date, the Company refinances each repurchase agreement at the market interest rate at that time. Since the interest rate on its repurchase agreements change on a one to twelve month basis, the Company is exposed to changing interest rates. The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

Our other income (loss) relates to the unrealized loss on interest rate swaps of approximately \$764,000 (2010: \$90,000; 2009: \$0) which represents the ineffective portion of the change in fair value of our interest rate swaps which is recognized directly in earnings for the year ended December 31, 2011.

**Expenses**

For the year ended December 31, 2011, we incurred management fees of \$26.3 million (2010: \$8.1 million; 2009: \$1.5 million), which are payable to our Manager under our management agreement. The increase in management fees is the result of higher average equity under management as a result of our follow-on common stock offerings. See Certain Relationships, Related Transactions, and Director Independence for a discussion of the management fee and our relationship with our Manager.

For the year ended December 31, 2011, our general and administrative expense of approximately \$3.9 million (2010: \$4.0 million; 2009: \$2.0 million) include operating expenses not covered under our management agreement. These expenses primarily consist of directors and officers insurance, accounting services, auditing and tax services, filing fees, and miscellaneous general and administrative costs. The increase in costs from 2009 to 2010 is as a result of our first full year of operation in 2010.

**Net Income and Return on Average Equity**

For the year ended December 31, 2011, our net income was \$286.8 million (2010: \$103.7 million; 2009: \$17.5 million) and our annualized return on average equity was 17.64% (2010: 17.58%; 2009: 19.35%) The change in net income and average return on equity was primarily the result of increasing our investment portfolio from the proceeds of our common stock offerings and the changes in our portfolio composition during 2011 and 2010.

**Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to pay dividends, fund investments, repayment of borrowings and other general business needs. Our primary sources of funds for liquidity consists of the net proceeds from our common equity offerings, net cash provided by operating activities, cash from repurchase agreements and other financing arrangements and future issuances of equity and/or debt securities. We also have sought, and may continue to finance our assets under, and may otherwise participate in, programs established by the U.S. government.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings, margin requirements and the payment of cash dividends as required for continued qualification as a REIT. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on our balance sheet is significantly less important than our potential liquidity available under borrowing arrangements.

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We held cash and cash equivalents of approximately \$197.2 million at December 31, 2011 (2010: \$63.6 million). Our cash and cash equivalents increased due to normal fluctuations in cash balances related to the timing of principal and interest payments, repayments of debt, and asset purchases and sales.

Our operating activities provided net cash of approximately \$305.4 million for the year ended December 31, 2011 (2010: \$71.5 million; 2009: \$11.5 million). The cash provided by operating activities increased due to the increase in net interest income earned by the portfolio which resulted from the increase in average interest earning assets of \$11.0 billion in investments at December 31, 2011 as compared to \$2.7 billion at December 31, 2010 and \$866.4 million at December 31, 2009.

Our investing activities used net cash of \$9.1 billion for the year ended December 31, 2011 (2010: \$4.4 billion; 2009: \$793.2 million). During the year ended December 31, 2011 we utilized cash to purchase \$13.7 billion in securities which were offset by proceeds from asset sales of \$3.1 billion and principal payments of \$1.5 billion. During the year ended December 31, 2010 we utilized cash to purchase \$5.1 billion in securities which were offset by proceeds from asset sales of \$260.1 million and principal payments of \$420.6 million. During the year ended December 31, 2009 we utilized cash to purchase \$961.4 million in securities and sold \$100.6 million and received principal payments of \$72.0 million. During 2011 and 2010, we utilized proceeds generated from our financing activities to increase our investment portfolio, resulting in an increase in purchases of mortgage-backed securities and an increase in principal payments.

Our financing activities for the year ended December 31, 2011 consisted of net proceeds from our follow-on common stock offerings in which we raised approximately \$1.3 billion in equity and net proceeds from our repurchase agreements of \$7.9 billion.

Our financing activities for the year ended December 31, 2010 consisted of net proceeds from our follow-on common stock offerings in which we raised approximately \$830.8 million in equity and net proceeds from our repurchase agreements of \$3.8 billion.

Our financing activities for the year ended December 31, 2009 consisted of net proceeds from our initial public offering in which we raised approximately \$171.6 million in equity and net proceeds from our repurchase agreements of \$0.5 billion.

The table below shows the allocation of our equity and debt-to-equity ratio as of December 31, 2011. The leverage on each class of assets may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense while maintaining our overall portfolio leverage guidelines.

| <b>\$ in thousands</b> | <b>Agency</b> | <b>Non-Agency</b> | <b>CMBS</b> | <b>Unconsolidated<br/>Ventures</b> | <b>Total</b> |
|------------------------|---------------|-------------------|-------------|------------------------------------|--------------|
| Borrowings             | 9,491,538     | 1,916,620         | 844,880     | -                                  | 12,253,038   |
| Equity allocation      | 1,055,869     | 470,694           | 322,057     | 68,793                             | 1,917,413    |
| Debt / Equity Ratio    | 9.0           | 4.1               | 2.6         | -                                  | 6.4          |
| % of Total Equity      | 55.1 %        | 24.5 %            | 16.8 %      | 3.6 %                              | 100.0 %      |

As of December 31, 2011, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the haircut, under our repurchase agreements for Agency RMBS was approximately 4.77% (weighted by borrowing amount), under our repurchase agreements for non-Agency RMBS was approximately 19.15% and under our repurchase agreements for CMBS was approximately 19.72%. Across our repurchase facilities for Agency RMBS, the haircuts range from a low of 3% to a high of 8%, for non-Agency RMBS range from a low of 10% to a high of 40% and for CMBS range from a low of 12% to a high of 30%. The weighted average margin requirements have not significantly changed since September 30, 2011. Our hedged cost of funds was approximately 1.64% and 1.40% as of December 31, 2011 and 2010,

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respectively. Declines in the value of our securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all repurchase transactions existing with us and require any amount due by us to the counterparties to be payable immediately.

As discussed above under Market Conditions, the residential mortgage market in the United States has experienced difficult economic conditions including:

increased volatility of many financial assets, including agency securities and other high-quality RMBS assets, due to potential security liquidations;

increased volatility and deterioration in the broader residential mortgage and RMBS markets; and

significant disruption in financing of RMBS.

If these conditions persist, then our lenders may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of required equity capital or haircut, any of which could make it more difficult or costly for us to obtain financing. In addition, because Fannie Mae and Freddie Mac are in conservatorship of the U.S. government, if the U.S.'s credit rating is downgraded, it may impact the credit risk associated with Agency RMBS and other assets, and, therefore, decrease the value of the Agency RMBS, non-Agency RBMS and CMBS in our portfolio, which could cause our repurchase counterparties to make margin calls on our borrowings and swaps, if our collateral is insufficient to cover the debt secured by our assets.

Effective as of August 27, 2010, we implemented a dividend reinvestment and stock purchase plan (the DRSP), pursuant to which we registered and reserved for issuance 2,000,000 shares of our common stock. Under the terms of the DRSP, shareholders who participate in the DRSP may purchase shares of our common stock directly from us, in cash investments up to \$10,000. At our sole discretion, we may accept optional cash investments in excess of \$10,000 per month, which may qualify for a discount from the market price of 0% to 3%. The DRSP participants may also automatically reinvest all or a portion of their dividends for additional shares of our stock. We expect to use the proceeds from any dividend reinvestments or stock purchases for general corporate purposes. During the year ended December 31, 2011, we issued 4,121,638 shares of common stock (2010: 0 shares) under the share purchase feature of our DRSP. During the year ended December 31, 2011, we issued a total of 11,912 shares of common stock (2010: 11 shares) pursuant to dividend reinvestment feature of our DRSP.

On December 13, 2011, we announced a share repurchase program that was approved by our Board of Directors for up to 7 million shares of our common stock. The shares may be repurchased from time to time through privately negotiated transactions or open market transactions, including pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Exchange Act or by any combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors, including market conditions and applicable SEC rules. As of December 31, 2011, we have not repurchased any shares under this program.

*Effects of Margin Requirements, Leverage and Credit Spreads*

Our securities have values that fluctuate according to market conditions and, as discussed above, the market value of our securities will decrease as prevailing interest rates or credit spreads increase. When the value of the securities pledged to secure a repurchase loan decreases to the point where the positive difference between the collateral value and the loan amount is less than the haircut, our lenders may issue a margin call, which means that the lender will require us to pay the margin call in cash or pledge additional collateral to meet that margin call. Under our repurchase facilities, our lenders have full discretion to determine the value of the securities we pledge to them. Most of our lenders will value securities based on recent trades in the market. Lenders also issue margin calls as the published current principal balance factors change on the pool of mortgages underlying the securities pledged as collateral when scheduled and unscheduled paydowns are announced monthly.



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We experience margin calls in the ordinary course of our business. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our liquidity. The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, then the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline, we will experience margin calls, and we will use our liquidity to meet the margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. In addition, if we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness.

We intend to maintain a level of liquidity in relation to our assets that enables us to meet reasonably anticipated margin calls but that also allows us to be substantially invested in securities. We may misjudge the appropriate amount of our liquidity by maintaining excessive liquidity, which would lower our investment returns, or by maintaining insufficient liquidity, which would force us to liquidate assets into unfavorable market conditions and harm our results of operations and financial condition.

*Forward-Looking Statements Regarding Liquidity*

Based upon our current portfolio, leverage rate and available borrowing arrangements, we believe that cash flow from operations and available borrowing capacity, will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements to fund our investment activities, pay fees under our management agreement, fund our distributions to shareholders and for other general corporate expenses.

Our ability to meet our long-term (greater than one year) liquidity and capital resource requirements will be subject to obtaining additional debt financing. We may increase our capital resources by obtaining long-term credit facilities or through public or private offerings of equity or debt securities, possibly including classes of preferred stock, common stock, and senior or subordinated notes. Such financing will depend on market conditions for capital raises and our ability to invest such offering proceeds. If we are unable to renew, replace or expand our sources of financing on substantially similar terms, it may have an adverse effect on our business and results of operations.

**Contractual Obligations**

On July 1, 2009, we entered into an agreement with our Manager pursuant to which our Manager is entitled to receive a management fee and the reimbursement of certain expenses, which was amended on May 24, 2011. The management fee will be calculated and payable quarterly in arrears in an amount equal to 1.50% of our shareholders' equity, per annum, calculated and payable quarterly in arrears. Our Manager uses the proceeds from its management fee in part to pay compensation to its officers and personnel who, notwithstanding that certain of those individuals are also our officers, receive no cash compensation directly from us. We are required to reimburse our Manager for operating expenses related to us incurred by our Manager, including certain salary expenses and other expenses relating to legal, accounting, due diligence and other services. Expense reimbursements to our 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. Refer to Note 8 Related Party Transactions for details of our reimbursements to our Manager.

**Contractual Commitments**

As of December 31, 2011, we had the following contractual commitments and commercial obligations:

| \$ in thousands                      | Total             | Payments Due by Period |           |           |               |
|--------------------------------------|-------------------|------------------------|-----------|-----------|---------------|
|                                      |                   | Less than 1<br>year    | 1-3 years | 3-5 years | After 5 years |
| Repurchase agreements                | 12,253,038        | 12,253,038             | -         | -         | -             |
| Equity Investments                   | 20,319            | 20,319                 | -         | -         | -             |
| <b>Total contractual obligations</b> | <b>12,273,357</b> | <b>12,273,357</b>      | <b>-</b>  | <b>-</b>  | <b>-</b>      |



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As of December 31, 2011, we have approximately \$11.9 million in contractual interest payments related to our repurchase agreements.

**Off-Balance Sheet Arrangements**

We committed to invest up to \$100.0 million in the Invesco IMRF Fund, which, in turn, invests in our target assets. As of December 31, 2011 and 2010, approximately \$79.7 million and \$61.0 million of the commitment has been called, respectively.

We also utilize credit derivatives, such as credit default swaps, to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable us to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to us and we agree to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event.

Although contract-specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the CDS's notional amount is recorded as realized loss in the statement of operations.

Our only CDS contract was entered into on December 30, 2010 with a \$150.0 million notional balance where we sold protection on a specific pool of non-Agency RMBS that exceed a specified loss limit of 25% for a stated fixed rate fee of 3%. Our maximum exposure is the unpaid principal balance of the underlying RMBS that exceeds the specified loss limit. We posted cash collateral to secure potential loss payments of \$17.3 million as of December 31, 2011. The remaining notional amount of the CDS at December 31, 2011 is \$112.1 million compared to \$150.0 million at December 31, 2010, and we estimated the fair market value of the CDS to be approximately \$1.3 million at December 31, 2011 compared to \$0 million at December 31, 2010. As of December 31, 2011, we have not made any payments related to the CDS contract.

**Shareholders' Equity**

On March 25, 2011, the Company completed a follow-on common stock offering of 19,000,000 shares of common stock and an issuance of an additional 2,850,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.07 per share. Net proceeds to the Company were \$460.1 million, net of issuance costs of approximately \$317,000.

On June 23, 2011, the Company completed a follow-on common stock offering of 17,000,000 shares of common stock and an issuance of an additional 2,550,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$20.15 per share. Net proceeds to the Company were \$388.8 million, net of issuance costs of approximately \$5.1 million.

On August 23, 2011, the Company completed a follow-on common stock offering of 20,000,000 shares of common stock at \$18.37 per share. Net proceeds to the Company were \$362.3 million, net of issuance costs of approximately \$5.1 million.

During the year ended December 31, 2011, the Company issued 4,121,638 shares of common stock at an average price of \$20.93 under the share repurchase feature of the Company's Dividend Reinvestment and Share Purchase Plan (DRSPP) with total proceeds to the Company of approximately \$85.8 million, net of issuance costs.

**Unrealized Gains and Losses**

Since we account for our investment securities as available-for-sale, unrealized fluctuations in market values of assets do not impact our U.S. GAAP income but rather are reflected on our balance sheet by changing the

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carrying value of the asset and shareholders' equity under Accumulated Other Comprehensive Income (Loss). In addition, unrealized fluctuations in market values of our cash flow hedges that qualify for hedge accounting are also reflected in Accumulated Other Comprehensive Income (Loss). For the year ended December 31, 2011, net unrealized losses included in shareholders' equity is \$423.9 million (2010: \$17.8 million gain; 2009: \$8.9 million gain).

The net unrealized loss is primarily attributable to changes in the market values of our cash flow hedges that qualify for hedge accounting. Refer to Note 3 Mortgage-Backed Securities and Note 6 Derivative and Hedging Activities for more details on the unrealized gains and losses in both our investment securities and our cash flow hedges.

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful.

**Share-Based Compensation**

We established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to our independent, non-executive directors, and to the officers and employees of the Manager (the Incentive Plan). Under the Incentive Plan, a total of 1,000,000 shares are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. Our three independent, non-executive directors are each eligible to receive \$50,000 in restricted common stock annually. For the year ended December 31, 2011, we recognized compensation expense of approximately \$143,000 (2010: \$105,000; 2009: \$38,000) and issued 7,053 shares (2010: 4,173 shares; 2009: 912 shares) of restricted stock to our independent, non-executive directors pursuant to the Incentive Plan. The number of shares issued was determined based on the closing price on the NYSE on the actual date of grant.

**Dividends**

We intend to continue to make regular quarterly distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income, determined 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 distributes less than 100% of its taxable income. We intend to pay regular quarterly dividends to our shareholders in an amount equal at least 90% of our net taxable income. 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 debt 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.

**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 than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates.

**Other Matters**

We calculate that we satisfied each of the asset tests in Section 856(c)(4) of the Internal Revenue Code of 1986, as amended (the Code) at the end of each calendar quarter in 2011. We also calculate that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the taxable year ended December 31, 2011. Consequently, we believe that we met the REIT income and asset test for 2011. We also met all REIT requirements regarding the ownership of our common stock and the distribution of dividends for the taxable year ended December 31, 2011. Therefore, as of December 31, 2011, we believe that we qualified as a REIT under the Code.

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At all times, we intend to conduct our business so that neither we nor our Operating Partnership nor the subsidiaries of our Operating Partnership are required to register as an investment company under the 1940 Act. If we were required to register as an investment company, then our use of leverage would be substantially reduced. Because we are a holding company that conducts our business through our Operating Partnership and the Operating Partnership's wholly-owned or majority-owned subsidiaries, the securities issued by these subsidiaries that are excepted from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the Operating Partnership may own, may not have a combined value in excess of 40% of the value of the Operating Partnership's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis, which we refer to as the 40% test. This requirement limits the types of businesses in which we are permitted to engage in through our subsidiaries. In addition, we believe neither we nor the Operating Partnership are considered an investment company under Section 3(a)(1)(A) of the 1940 Act because they do not engage primarily or hold themselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through the Operating Partnership's wholly-owned or majority-owned subsidiaries, we and the Operating Partnership are primarily engaged in the non-investment company businesses of these subsidiaries. IAS Asset I LLC and certain of the Operating Partnership's other subsidiaries that we may form in the future rely upon the exclusion from the definition of investment company under the 1940 Act provided by Section 3(c)(5)(C) of the 1940 Act, which is available for entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. This exclusion generally requires that at least 55% of each subsidiary's portfolio be comprised of qualifying assets and at least 80% be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose include mortgage loans fully secured by real estate and other assets, such as whole pool Agency and non-Agency RMBS, that the SEC or its staff in various no-action letters has determined are the functional equivalent of mortgage loans fully secured by real estate. We treat as real estate-related assets CMBS, debt and equity securities of companies primarily engaged in real estate businesses, Agency partial pool certificates and securities issued by pass-through entities of which substantially all of the assets consist of qualifying assets and/or real estate-related assets. Additionally, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the MBS may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of December 31, 2011, we conducted our business so as not to be regulated as an investment company under the 1940 Act.

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

The primary components of our market risk are related to interest rate, prepayment and market value. While we do not seek to avoid risk completely, we believe the risk can be quantified from historical experience and we seek to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

**Interest Rate Risk**

Interest rate risk is highly sensitive to many factors, including governmental, monetary and tax policies, domestic and international economic and political considerations, and other factors beyond our control. We are subject to interest rate risk in connection with our investments and our repurchase agreements. Our repurchase agreements are typically of limited duration and will be periodically refinanced at current market rates. We mitigate this risk through utilization of derivative contracts, primarily interest rate swap agreements, interest rate caps and interest rate floors.

**Interest Rate Effect on Net Interest Income**

Our operating results depend in large part upon differences between the yields earned on our investments and our cost of borrowing and interest rate hedging activities. Most of our repurchase agreements provide financing based on a floating rate of interest calculated on a fixed spread over LIBOR. The fixed spread will vary depending on the type of underlying asset which collateralizes the financing. Accordingly, the portion of our portfolio which consists of floating interest rate assets are match-funded utilizing our expected sources of short-term financing, while our fixed interest rate assets are not match-funded. During periods of rising interest rates, the borrowing costs associated with our investments tend to increase while the income earned on our fixed interest rate investments may

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remain substantially unchanged. This increase in borrowing costs results in the narrowing of the net interest spread between the related assets and borrowings and may even result in losses. Further, during this portion of the interest rate and credit cycles, defaults could increase and result in credit losses to us, which could adversely affect our liquidity and operating results. Such delinquencies or defaults could also have an adverse effect on the spread between interest-earning assets and interest-bearing liabilities.

Hedging techniques are partly based on assumed levels of prepayments of our RMBS. If prepayments are slower or faster than assumed, the life of the RMBS 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.

### **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.

We primarily assess our interest rate risk by estimating the duration of our assets and the duration of our liabilities. Duration measures the market price volatility of financial instruments as interest rates change. We generally calculate duration using various financial models and empirical data. Different models and methodologies can produce different duration numbers for the same securities.

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.

### **Prepayment Risk**

As we receive prepayments of principal on our investments, premiums paid on these investments are amortized against interest income. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the investments. Conversely, discounts on such investments are accreted into interest income. In general, an increase in prepayment rates will accelerate the accretion of purchase discounts, thereby increasing the interest income earned on the investments.

### **Extension Risk**

We compute the projected weighted-average life of our investments based upon assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a fixed-rate or hybrid adjustable-rate security is acquired with borrowings, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related assets. This strategy is designed to protect us from rising interest rates, because the borrowing costs are fixed for the duration of the fixed-rate portion of the related target asset.

However, if prepayment rates decrease in a rising interest rate environment, then the life of the fixed-rate portion of the related assets could extend beyond the term of the swap agreement or other hedging instrument. This could have a negative impact on our results from operations, as borrowing costs would no longer be fixed after the end of the hedging instrument, while the income earned on the hybrid adjustable-rate assets would remain fixed. This situation may also cause the market value of our hybrid adjustable-rate assets to decline, with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could cause us to incur losses.

**Table of Contents****Index to Financial Statements****Market Risk***Market Value Risk*

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income pursuant to ASC Topic 320. The estimated fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the estimated fair value of these securities would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated 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 and net interest income, at December 31, 2011, assuming a static portfolio. 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 utilized assumptions, models and estimates of our Manager based on our Manager's judgment and experience.

| Change in Interest Rates | Percentage Change in Projected<br>Net Interest Income | Percentage Change in Projected<br>Portfolio Value |
|--------------------------|---|---|
| +1.00%                   | 8.75 %  | (0.94)%   |
| +0.50%                   | 15.06 %   | (0.27)%   |
| -0.50%                   | (21.03)%  | (0.07)%   |
| -1.00%                   | (44.57)%  | (0.50)%   |

*Real Estate Risk*

Residential and commercial property values are subject to volatility and may be affected adversely by a number of factors, including, but not limited to: national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as the supply of housing stock); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses.

**Credit Risk**

We believe that our investment strategy will generally keep our credit losses and financing costs low. However, we retain the risk of potential credit losses on all of the residential and commercial mortgage loans, as well as the loans underlying the non-Agency RMBS and CMBS in our portfolio. We seek to manage this risk through our pre-acquisition due diligence process and through the use of non-recourse financing, which limits our exposure to credit losses to the specific pool of mortgages that are subject to the non-recourse financing. In addition, with respect to any particular asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral.

**Risk Management**

To the extent consistent with maintaining our REIT qualification, we seek to manage risk exposure to protect our investment portfolio against the effects of major interest rate changes. We generally seek to manage this risk by:

monitoring and adjusting, if necessary, the reset index and interest rate related to our target assets and our financings;

attempting to structure our financing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;

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using hedging instruments, primarily interest rate swap agreements but also financial futures, options, interest rate cap agreements, floors and forward sales to adjust the interest rate sensitivity of our target assets and our borrowings; and

actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of our target assets and the interest rate indices and adjustment periods of our financings.

#### **Item 8. Financial Statements and Supplementary Data.**

The financial statements and supplementary data are included under Item 15 of this Report.

#### **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

#### **Item 9A. Controls and Procedures.**

##### **Disclosure 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 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 December 31, 2011. 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.

##### **Management's Annual Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in the Exchange Act, Rules 13a-15(f) and 15d-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



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Under the supervision and with the participation of the chief executive officer and chief financial officer, management assessed the effectiveness of our internal control over financial reporting as of December 31, 2011. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control – Integrated Framework. Based on this assessment, management concluded that our internal control over financial reporting was effective as of December 31, 2011.

Our independent auditors, Grant Thornton LLP, audited our internal control over financial reporting as of December 31, 2011. Their report dated February 29, 2012, which is included herein, expressed an unqualified opinion on our internal control over financial reporting.

**Changes in Internal Control over Financial Reporting**

No change occurred in our internal control over financial reporting (as defined in Rule-15(f) and 15d-15(f) of the Exchange Act) during our fourth fiscal quarter ended December 31, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information.**

None.

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance.**

We will provide information that is responsive to certain portions of this Item 10 in our definitive proxy statement or in an amendment to this Report not later than 120 days after the end of the fiscal year covered by this Report, in either case under the captions Information about Director Nominees, Information about the Executive Officers of the Company, Corporate Governance, Information about the Board and its Committees, Section 16(a) Beneficial Ownership Reporting Compliance, and possibly elsewhere therein. That information is incorporated into this Item 10 by reference.

Each year, the chief executive officer of each company listed on the New York Stock Exchange ( NYSE ) must certify to the NYSE that he or she is not aware of any violation by us of NYSE corporate governance listing standards as of the date of certification, qualifying the certification to the extent necessary. Our chief executive officer submitted our first required certification to the NYSE in August of 2010, and will submit a similar certification within 30 days of our 2012 annual shareholders meeting. In addition, we have filed, as exhibits to this Report, the certifications of our chief executive officer and chief financial officer required under Section 302 and 906 of the Sarbanes-Oxley Act of 2002.

**Item 11. Executive Compensation.**

We will provide information that is responsive to this Item 11 in our definitive proxy statement or in an amendment to this Report not later than 120 days after the end of the fiscal year covered by this Report, in either case under the captions Director Compensation, Executive Compensation, Compensation Committee Interlocks and Insider Participation, and possibly elsewhere therein. That information is incorporated into this Item 11 by reference.

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**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

We will provide information that is responsive to this Item 12 in our definitive proxy statement or in an amendment to this Report not later than 120 days after the end of the fiscal year covered by this Report, in either case under the caption Security Ownership of Principal Shareholders, Security Ownership of Management, and possibly elsewhere therein. That information is incorporated into this Item 12 by reference.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

We will provide information that is responsive to this Item 13 in our definitive proxy statement or in an amendment to this Report not later than 120 days after the end of the fiscal year covered by this Report, in either case under the captions Corporate Governance, Certain Relationships and Related Transactions, Related Person Transaction Policy, and possibly elsewhere therein. That information is incorporated into this Item 13 by reference.

**Item 14. Principal Accountant Fees and Services.**

We will provide information that is responsive to this Item 14 in our definitive proxy statement or in an amendment to this Report not later than 120 days after the end of the fiscal year covered by this Report, in either case under the captions Fees Paid to Independent Registered Public Accounting Firm, Pre-Approval Process and Policy, and possibly elsewhere therein. That information is incorporated into this Item 14 by reference.

**PART IV**

**Item 15. Exhibits, Financial Statement Schedules.**

(a)(1) *Financial Statements*: The financial statements contained herein are set forth on pages 69-95 of this Report.

(a)(2) *Financial Statement Schedules*:

(a)(3) *Exhibits*:

**Exhibit Index**

| <b><u>Exhibit No.</u></b> | <b><u>Description</u></b>   |
|---------------------------|---|
| 3.1                       | Articles of Amendment and Restatement of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.1 to our Quarterly Report on Form 10-Q, filed with the SEC on August 12, 2009.   |
| 3.2                       | Amended and Restated Bylaws of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.2 to Amendment No. 8 to our Registration Statement on Form S-11 (No. 333-151665), filed with the SEC on June 18, 2009 ( Pre-Effective Amendment No. 8 ). |
| 4.1                       | Specimen Common Stock Certificate of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 4.1 to Pre-Effective Amendment No. 8.  |

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- 10.1 Registration Rights Agreement, dated as of July 1, 2009, among Invesco Mortgage Capital Inc. (formally known as Invesco Agency Securities Inc.), Invesco Advisers, Inc. (formally known as Invesco Institutional (N.A.), Inc.) and Invesco Investments (Bermuda) Ltd., incorporated by reference to Exhibit 10.1 to our Quarterly Report on Form 10-Q, filed with the SEC on August 12, 2009.
- 10.2 Management Agreement, dated as of July 1, 2009, among Invesco Advisers, Inc. (formally known as Invesco Institutional (N.A.), Inc.), Invesco Mortgage Capital Inc. and IAS Operating Partnership LP., incorporated by reference to Exhibit 10.2 to our Quarterly Report on Form 10-Q, filed with the SEC on August 12, 2009.
- 10.3 Amendment to Management Agreement, dated as of May 24, 2011, by and among Invesco Advisers, Inc. (formally known as Invesco Institutional (N.A.), Inc.), Invesco Mortgage Capital Inc., IAS Operating Partnership LP., and IAS Asset I LLC, incorporated by reference to Exhibit 10.1 to our Quarterly Report on Form 10-Q, filed with the SEC on August 9, 2011.
- 10.4 First Amended and Restated Agreement of Limited Partnership, dated as of July 1, 2009, of IAS Operating Partnership LP., incorporated by reference to Exhibit 10.3 to our Quarterly Report on Form 10-Q, filed with the SEC on August 12, 2009.
- 10.5§ Invesco Mortgage Capital Inc. 2009 Equity Incentive Plan, incorporated by reference to Exhibit 10.4 to our Quarterly Report on Form 10-Q, filed with the SEC on November 9, 2009.
- 10.6§ Amendment No. 1 to Invesco Mortgage Capital Inc. 2009 Equity Incentive Plan, incorporated by reference to Exhibit 10.1 to our Quarterly Report on Form 10-Q, filed with the SEC on August 13, 2010.
- 10.7§ Form of Restricted Common Stock Award Agreement, incorporated by reference to Exhibit 4.1 to Pre-Effective Amendment No. 8.
- 10.8§ Form of Stock Option Award Agreement, incorporated by reference to Exhibit 4.1 to Pre-Effective Amendment No. 8.
- 10.9§ Form of Restricted Stock Unit Award Agreement, incorporated by reference to Exhibit 10.7 to our Annual Report on Form 10-K, filed with the SEC on March 24, 2010.
- 21.1 Subsidiaries of the Registrant.
- 23.1 Consent of Grant Thornton LLP.
- 31.1 Certification of Richard J. King pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Donald R. Ramon pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Richard J. King pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Donald R. Ramon pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following series of audited XBRL-formatted documents are collectively included herewith as Exhibit 101. The financial information is extracted from Invesco Mortgage Capital Inc.'s audited consolidated financial statements and notes that are included in this Form 10-K Report.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

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101.CAL XBRL Taxonomy Calculation Linkbase Document

101.LAB XBRL Taxonomy Label Linkbase Document

101.PRE XBRL Taxonomy Presentation Linkbase Document

101.DEF XBRL Taxonomy Definition Linkbase Document

§ Management contract or compensatory plan or arrangement.

(b) *Exhibits*: See (a)(3) above.

(c) *Financial Statement Schedules*: See (a)(2) above.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders

Invesco Mortgage Capital Inc.

We have audited the accompanying consolidated balance sheets of Invesco Mortgage Capital Inc. (a Maryland corporation) and its subsidiaries (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of operations, comprehensive income(loss), changes in equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Invesco Mortgage Capital Inc. and its subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 29, 2012, expressed an unqualified opinion on internal control over financial reporting.

/s/ GRANT THORNTON LLP

Philadelphia, Pennsylvania

February 29, 2012

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders

Invesco Mortgage Capital Inc.

We have audited Invesco Mortgage Capital Inc. (a Maryland Corporation) and its subsidiaries (the Company) internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's Annual Report on Internal Control over Financial Reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Invesco Mortgage Capital Inc. and its subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Invesco Mortgage Capital Inc. and its subsidiaries as of December 31, 2011 and 2010 and the related consolidated statements of operations, comprehensive income(loss), changes in equity, and cash flows for each of the three years in the period ended December 31, 2011, and our report dated February 29, 2012 expressed an unqualified opinion.

/s/ GRANT THORNTON LLP

Philadelphia, Pennsylvania

February 29, 2012

**Table of Contents****Index to Financial Statements****INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

\$ in thousands, except per share amounts

| ASSETS   | December 31,<br>2011 | As of<br>December 31,<br>2010 |
|--|----------------------|-------------------------------|
| Mortgage-backed securities, at fair value  | 14,214,149           | 5,578,333                     |
| Cash   | 197,224              | 63,552                        |
| Restricted cash  | 74,496               | 101,144                       |
| Investment related receivable  | 160,424              | 7,601                         |
| Investments in unconsolidated ventures, at fair value  | 68,793               | 54,725                        |
| Accrued interest receivable  | 54,167               | 22,503                        |
| Derivative assets, at fair value   | 1,339                | 33,255                        |
| Other assets   | 1,575                | 1,287                         |
| <b>Total assets</b>  | <b>14,772,167</b>    | <b>5,862,400</b>              |
| <b>LIABILITIES AND EQUITY</b>  |                      |                               |
| <b>Liabilities:</b>  |                      |                               |
| Repurchase agreements  | 12,253,038           | 4,344,659                     |
| Derivative liability, at fair value  | 396,780              | 37,850                        |
| Dividends and distributions payable  | 75,933               | 49,741                        |
| Investment related payable   | 107,032              | 372,285                       |
| Accrued interest payable   | 12,377               | 2,579                         |
| Accounts payable and accrued expenses  | 556                  | 1,065                         |
| Due to affiliate   | 9,038                | 3,407                         |
| <b>Total liabilities</b>   | <b>12,854,754</b>    | <b>4,811,586</b>              |
| <b>Equity:</b>   |                      |                               |
| Preferred Stock: par value \$0.01 per share; 50,000,000 shares authorized, 0 shares issued and outstanding   | -                    | -                             |
| Common Stock: par value \$0.01 per share; 450,000,000 shares authorized, 115,395,695 and 49,854,196 shares issued and outstanding, at December 31, 2011 and 2010, respectively | 1,154                | 499                           |
| Additional paid in capital   | 2,299,543            | 1,002,809                     |
| Accumulated other comprehensive income (loss)  | (393,291)            | 24,015                        |
| Distributions in excess of earnings  | (15,068)             | (8,173)                       |
| <b>Total shareholders equity</b>   | <b>1,892,338</b>     | <b>1,019,150</b>              |
| Non-controlling interest   | 25,075               | 31,664                        |
| <b>Total equity</b>  | <b>1,917,413</b>     | <b>1,050,814</b>              |
| <b>Total liabilities and equity</b>  | <b>14,772,167</b>    | <b>5,862,400</b>              |

The accompanying notes are an integral part of these consolidated financial statements.





**Table of Contents****Index to Financial Statements****INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

| \$ in thousands, except per share data                                   | Years Ended December 31, |                |               |
|--|--------------------------|----------------|---------------|
|  | 2011                     | 2010           | 2009          |
| <b>Revenues</b>  |                          |                |               |
| Interest income  | 453,352                  | 134,229        | 23,529        |
| Interest expense   | 155,241                  | 29,556         | 4,627         |
| <b>Net interest income</b>   | <b>298,111</b>           | <b>104,673</b> | <b>18,902</b> |
| <b>Other income</b>  |                          |                |               |
| Gain on sale of investments, net   | 10,959                   | 3,456          | 2,002         |
| Equity in earnings and fair value change in unconsolidated ventures, net | 3,301                    | 8,276          | 71            |
| Loss on other-than-temporarily impaired securities                       | -                        | (510)          | -             |
| Unrealized loss on interest rate swaps                                   | (764)                    | (90)           | -             |
| Realized and unrealized credit default swap income                       | 5,308                    | 13             | -             |
| <b>Total other income</b>  | <b>18,804</b>            | <b>11,145</b>  | <b>2,073</b>  |
| <b>Expenses</b>  |                          |                |               |
| Management fee related party   | 26,259                   | 8,080          | 1,513         |
| General and administrative   | 3,859                    | 4,013          | 1,951         |
| <b>Total expenses</b>  | <b>30,118</b>            | <b>12,093</b>  | <b>3,464</b>  |
| Net income   | 286,797                  | 103,725        | 17,511        |
| Net income attributable to non-controlling interest                      | 4,882                    | 5,326          | 2,417         |
| Net income attributable to common shareholders                           | 281,915                  | 98,399         | 15,094        |
| <b>Earnings per share:</b>   |                          |                |               |
| Net income attributable to common shareholders (basic/diluted)           | 3.27                     | 3.78           | 3.37          |
| Dividends declared per common share                                      | 3.42                     | 3.49           | 1.66          |
| <b>Weighted average number of shares of common stock:</b>                |                          |                |               |
| Basic  | 86,365                   | 26,039         | 4,480         |
| Diluted  | 87,804                   | 27,468         | 5,198         |

The accompanying notes are an integral part of these consolidated financial statements.



**Table of Contents****Index to Financial Statements****INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

| <b>\$ in thousands, except per share data</b>                   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2011</b>                     | <b>2010</b> | <b>2009</b> |
| Net income  | 286,797                         | 103,725     | 17,511      |
| Other comprehensive income (loss)                               |                                 |             |             |
| Unrealized gains (losses) on available for sale securities, net | (32,485)                        | 18,526      | 12,741      |
| Unrealized losses on derivatives, net                           | (391,421)                       | (722)       | (3,782)     |
| Other comprehensive income (loss)                               | (423,906)                       | 17,804      | 8,959       |
| Comprehensive income (loss)                                     | (137,109)                       | 121,529     | 26,470      |
| Less: comprehensive (income) loss attributable to non-          |                                 |             |             |
| controlling interest  | 1,718                           | (6,836)     | (3,655)     |
| Comprehensive income (loss) attributable to common              |                                 |             |             |
| shareholders  | (135,391)                       | 114,693     | 22,815      |

The accompanying notes are an integral part of these consolidated statements.

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## INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF EQUITY

## Attributable to Common Shareholders

| \$ in thousands, except per share amounts                         | Common Stock |         | Additional Paid in Capital | Accumulated Other Comprehensive Income (Loss) | Distributions in excess of earnings | Total Shareholders Equity (Deficit) | Non-Controlling Interest | Total Equity |
|---|--------------|---------|----------------------------|---|-------------------------------------|-------------------------------------|--------------------------|--------------|
|   | Shares       | Amounts |                            |   |                                     |                                     |                          |              |
| <b>Balance at December 31, 2008</b>                               | 100          | -       | 1                          | -   | (22)                                | (21)                                | -                        | (21)         |
| Net income  | -            | -       | -                          | -   | 15,094                              | 15,094                              | 2,417                    | 17,511       |
| Other comprehensive income  | -            | -       | -                          | 7,721   | -                                   | 7,721                               | 1,238                    | 8,959        |
| Net proceeds from issuance of common stock, net of offering costs | 8,886,200    | 89      | 172,352                    | -   | -                                   | 172,441                             | -                        | 172,441      |
| Proceeds from private placement of OP units                       | -            | -       | -                          | -   | -                                   | -                                   | 28,500                   | 28,500       |
| Common stock dividends  | -            | -       | -                          | -   | (14,752)                            | (14,752)                            | -                        | (14,752)     |
| Common unit dividends   | -            | -       | -                          | -   | -                                   | -                                   | (2,366)                  | (2,366)      |
| Amortization of equity-based compensation                         | 912          | -       | 32                         | -   | -                                   | 32                                  | 6                        | 38           |
| <b>Balance at December 31, 2009</b>                               | 8,887,212    | 89      | 172,385                    | 7,721   | 320                                 | 180,515                             | 29,795                   | 210,310      |
| Net income  | -            | -       | -                          | -   | 98,399                              | 98,399                              | 5,326                    | 103,725      |
| Other comprehensive income  | -            | -       | -                          | 16,294  | -                                   | 16,294                              | 1,510                    | 17,804       |
| Net proceeds from issuance of common stock, net of offering costs | 40,962,811   | 410     | 830,301                    | -   | -                                   | 830,711                             | -                        | 830,711      |
| Stocks awards   | 4,173        | -       | -                          | -   | -                                   | -                                   | -                        | -            |
| Common stock dividends  | -            | -       | -                          | -   | (106,892)                           | (106,892)                           | -                        | (106,892)    |
| Common unit dividends   | -            | -       | -                          | -   | -                                   | -                                   | (4,973)                  | (4,973)      |
| Amortization of equity-based compensation                         | -            | -       | 123                        | -   | -                                   | 123                                 | 6                        | 129          |
| <b>Balance at December 31, 2010</b>                               | 49,854,196   | 499     | 1,002,809                  | 24,015  | (8,173)                             | 1,019,150                           | 31,664                   | 1,050,814    |

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|   |                    |              |                  |                  |                 |                  |               |                  |
|---|--------------------|--------------|------------------|------------------|-----------------|------------------|---------------|------------------|
| Net income  | -                  | -            | -                | -                | 281,915         | 281,915          | 4,882         | 286,797          |
| Other comprehensive loss  | -                  | -            | -                | (417,306)        | -               | (417,306)        | (6,600)       | (423,906)        |
| Net proceeds from issuance of common stock, net of offering costs | 65,533,550         | 655          | 1,296,545        | -                | -               | 1,297,200        | -             | 1,297,200        |
| Stocks awards   | 7,949              | -            | -                | -                | -               | -                | -             | -                |
| Common stock dividends  | -                  | -            | -                | -                | (288,810)       | (288,810)        | -             | (288,810)        |
| Common unit dividends   | -                  | -            | -                | -                | -               | -                | (4,874)       | (4,874)          |
| Amortization of equity-based compensation                         | -                  | -            | 189              | -                | -               | 189              | 3             | 192              |
| <b>Balance at December 31, 2011</b>                               | <b>115,395,695</b> | <b>1,154</b> | <b>2,299,543</b> | <b>(393,291)</b> | <b>(15,068)</b> | <b>1,892,338</b> | <b>25,075</b> | <b>1,917,413</b> |

The accompanying notes are an integral part of this consolidated financial statement.

**Table of Contents****Index to Financial Statements****INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

| \$ in thousands  | Years Ended December 31, |              |             |
|--|--------------------------|--------------|-------------|
|  | 2011                     | 2010         | 2009        |
| <b>Cash Flows from Operating Activities</b>                                      |                          |              |             |
| Net income   | 286,797                  | 103,725      | 17,511      |
| Adjustments to reconcile net income to net cash provided by operating activities |                          |              |             |
| Amortization of mortgage-backed securities premiums and discounts, net           | 50,110                   | (7,399)      | (1,764)     |
| Unrealized loss on interest swap   | 764                      | 90           | -           |
| Unrealized gain on credit default swap   | (1,339)                  | -            | -           |
| Gain on sale of mortgage-backed securities                                       | (10,959)                 | (3,456)      | (2,002)     |
| Loss on other-than-temporarily impaired securities                               | -                        | 510          | -           |
| Equity in earnings and fair value change in unconsolidated ventures              | (3,301)                  | (8,276)      | (71)        |
| Amortization of equity-based compensation  | 192                      | 129          | 38          |
| Increase in accrued interest receivable  | (31,664)                 | (18,985)     | (3,518)     |
| (Increase) decrease in other assets  | (288)                    | 167          | (390)       |
| Increase in accrued interest payable   | 9,798                    | 1,981        | 598         |
| Increase in due to affiliate   | 5,595                    | 2,542        | 756         |
| (Decrease) increase in accounts payable and accrued expenses                     | (342)                    | 501          | 320         |
| Net cash provided by operating activities  | 305,363                  | 71,529       | 11,478      |
| <b>Cash Flows from Investing Activities</b>                                      |                          |              |             |
| Purchase of mortgage-backed securities   | (13,747,267)             | (5,063,798)  | (961,356)   |
| Contributions to investment in unconsolidated ventures, net                      | (9,335)                  | (43,451)     | (4,359)     |
| Principal payments from mortgage-backed securities                               | 1,492,900                | 420,591      | 71,961      |
| Proceeds from sale of mortgage-backed securities                                 | 3,115,184                | 260,090      | 100,573     |
| Net cash used in investing activities  | (9,148,518)              | (4,426,568)  | (793,181)   |
| <b>Cash Flows from Financing Activities</b>                                      |                          |              |             |
| Proceeds from issuance of common stock   | 1,297,069                | 830,806      | 171,613     |
| Restricted cash  | 38,871                   | (92,660)     | (14,432)    |
| Investment related payable   | -                        | 11,050       | -           |
| Proceeds from private placement of OP Unit                                       | -                        | -            | 28,500      |
| Proceeds from repurchase agreements  | 92,911,002               | 20,545,015   | 2,766,266   |
| Principal repayments of repurchase agreements                                    | (85,002,623)             | (16,746,331) | (2,220,291) |
| Proceeds from TALF financing   | -                        | 71,526       | 80,407      |
| Principal payments of TALF financing   | -                        | (151,903)    | (30)        |
| Payments of dividends and distributions  | (267,492)                | (72,953)     | (6,290)     |
| Net cash provided by financing activities  | 8,976,827                | 4,394,550    | 805,743     |
| Net change in cash   | 133,672                  | 39,511       | 24,040      |
| Cash, beginning of period  | 63,552                   | 24,041       | 1           |

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|                     |         |        |        |
|---------------------|---------|--------|--------|
| Cash, end of period | 197,224 | 63,552 | 24,041 |
|---------------------|---------|--------|--------|

**Supplement disclosure of cash flow information**

|               |         |        |       |
|---------------|---------|--------|-------|
| Interest paid | 145,443 | 27,248 | 4,030 |
|---------------|---------|--------|-------|

**Non-cash investing and financing activities information**

|  |           |        |       |
|--|-----------|--------|-------|
| Net change in unrealized gain on available-for-sale securities and derivatives | (423,906) | 17,804 | 8,959 |
|--|-----------|--------|-------|

|                                       |         |       |     |
|---------------------------------------|---------|-------|-----|
| Net change in unconsolidated ventures | (1,432) | 1,130 | 302 |
|---------------------------------------|---------|-------|-----|

|                               |          |       |   |
|-------------------------------|----------|-------|---|
| Net change in restricted cash | (12,223) | 5,948 | - |
|-------------------------------|----------|-------|---|

|   |        |        |        |
|---|--------|--------|--------|
| Dividends and distributions declared not paid | 75,933 | 49,741 | 10,828 |
|---|--------|--------|--------|

|  |           |         |   |
|--|-----------|---------|---|
| Payable for mortgage-backed securities purchased | (431,732) | 363,753 | - |
|--|-----------|---------|---|

The accompanying notes are an integral part of these consolidated financial statements.



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**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Organization and Business Operations**

Invesco Mortgage Capital Inc. (the Company) is a Maryland corporation focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. The Company invests in residential mortgage-backed securities (RMBS) for which a U.S. Government Agency such as the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) guarantees payments of principal and interest on the securities (collectively Agency RMBS). The Company's Agency RMBS investments include mortgage pass-through securities and collateralized mortgage obligations (CMOs). The Company also invests in RMBS that are not issued or guaranteed by a U.S. government Agency (non-Agency RMBS), commercial mortgage-backed securities (CMBS), and residential and commercial mortgage loans. The Company is externally managed and advised by Invesco Advisers, Inc. (the Manager), a registered investment adviser and an indirect, wholly-owned subsidiary of Invesco Ltd. (Invesco), a global investment management company.

The Company conducts its business through IAS Operating Partnership LP (the Operating Partnership) as its sole general partner. As of December 31, 2011, the Company owned 98.8% of the Operating Partnership and Invesco Investments (Bermuda) Ltd., a direct, wholly-owned subsidiary of Invesco, owned the remaining 1.2%.

The Company finances its Agency RMBS, non-Agency RMBS and CMBS investments through short-term borrowings structured as repurchase agreements. The Manager has secured commitments for the Company with a number of repurchase agreement counterparties. The Company also finances its investments in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing capital to the Invesco Mortgage Recovery Feeder Fund that invests in public-private investment funds (PPIF) managed by the Company's Manager (Invesco IMRF Fund) as part of the Public-Private Investment Program (PPIP) created by the U.S. Treasury in conjunction with the Federal Deposit Insurance Corporation (the FDIC) and the Federal Reserve. In addition, the Company may use other sources of financing including committed borrowing facilities and other private financing.

The Company elected to be taxed as a real estate investment trust (REIT) for U.S. federal income tax purposes under the provisions of the Internal Revenue Code of 1986, as amended (Code), commencing with the Company's taxable year ended December 31, 2009. To maintain the Company's REIT qualification, the Company is generally required to distribute at least 90% of its taxable income to its shareholders annually.

**Note 2 Summary of Significant Accounting Policies**

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany balances and transactions have been eliminated.

**Use of Estimates**

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (U.S. GAAP). The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Examples of estimates include, but are not limited to, estimates of the fair values of financial instruments, interest income on mortgage-backed securities (MBS) and other-than-temporary impairment charges. Actual results may differ from those estimates.

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#### **Cash and Cash Equivalents**

The Company considers all highly liquid investments that have original or remaining maturity dates of three months or less when purchased to be cash equivalents. At December 31, 2011, the Company had cash and cash equivalents, including amounts restricted, in excess of the Federal Deposit Insurance Corporation, or FDIC, deposit insurance limit of \$250,000 per institution. The Company mitigates its risk of loss by placing cash and cash equivalents with numerous major financial institutions.

#### **Underwriting Commissions and Offering Costs**

Underwriting commissions and direct costs incurred in connection with the Company's initial public offering ( IPO ) and subsequent follow-on common stock offerings are reflected as a reduction of additional paid-in-capital.

#### **Repurchase Agreements**

The Company finances its Agency RMBS, non-Agency RMBS and its CMBS investment portfolio through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

In instances where the Company acquires Agency RMBS, non-Agency RMBS or CMBS through repurchase agreements with the same counterparty from whom such assets were purchased, the Company accounts for the purchase commitment and repurchase agreement on a net basis and records a forward commitment to purchase such assets as a derivative instrument if the transaction does not comply with the criteria for gross presentation. All of the following criteria must be met for gross presentation in the circumstance where the repurchase assets are financed with the same counterparty:

the initial transfer of and repurchase financing cannot be contractually contingent;

the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed;

the financial asset has an active market and the transfer is executed at market rates; and

the repurchase agreement and financial asset do not mature simultaneously.

If the transaction complies with the criteria for gross presentation, the Company records the assets and the related financing on a gross basis on its balance sheet and the corresponding interest income and interest expense in its statements of operations. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company records the cash portion of its investment in Agency RMBS and non-Agency RMBS as a mortgage related receivable from the counterparty on its balance sheet.

For assets representing available-for-sale investment securities any change in fair value is reported through consolidated other comprehensive income (loss) with the exception of impairment losses, which are recorded in the consolidated statement of operations.

#### **Fair Value Measurements**

In January 2010, the FASB updated guidance entitled, *Improving Disclosures about Fair Value Measurements*. The guidance required a number of additional disclosures regarding fair value measurements. Specifically, entities should disclose: (i) the amount of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers; (ii) the reasons for any transfers in or out of Level 3; and (iii) information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. Except for the requirement to disclose information about purchases, sales, issuances, and settlements in the reconciliation of recurring Level 3

measurements on a gross basis, all the amendments are

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effective for interim and annual reporting periods beginning after December 15, 2009. The Company adopted these provisions in preparing its Consolidated Financial Statements for the period ended March 31, 2010. The adoption of these provisions only affected the disclosure requirements for fair value measurements and as a result had no impact on the Company's consolidated statements of operations and consolidated balance sheets.

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels 1, 2, and 3, as defined). In accordance with U.S. GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level 3 category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities.

Additionally, U.S. GAAP permits entities to choose to measure many financial instruments and certain other items at fair value (the fair value option). Unrealized gains and losses on items for which the fair value option has been elected are irrevocably recognized in earnings at each subsequent reporting date.

The Company elected the fair value option for its investments in unconsolidated ventures. The Company has the one-time option to elect fair value for these financial assets on the election date. The changes in the fair value of these instruments are recorded in equity in earnings and fair value change in unconsolidated ventures in the consolidated statements of operations.

### **Securities**

The Company designates securities as held-to-maturity, available-for-sale, or trading depending on its ability and intent to hold such securities to maturity. Trading and securities available-for-sale are reported at fair value, while securities held-to-maturity are reported at amortized cost. Although the Company generally intends to hold most of its RMBS and CMBS until maturity, the Company may, from time to time, sell any of its RMBS or CMBS as part of its overall management of its investment portfolio and classifies its RMBS and CMBS as available-for-sale securities.

All securities classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity. When applicable, included with available-for-sale securities are forward purchase commitments on to be announced securities (TBA). The Company records TBA purchases on the trade date and the corresponding payable is recorded as an outstanding liability as a payable for investments purchased until the settlement date of the transaction. This is presented in the Investment related payable line item on the consolidated balance sheet.

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis and more frequently when economic or market conditions warrant such evaluation. The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of recovery, in fair value of the security, and (iii) the Company's intent and ability to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value.

For debt securities, the amount of the other-than-temporary impairment related to a credit loss or impairments on securities that the Company has the intent or for which it is more likely than not that the Company will need to sell before recovery are recognized in earnings and reflected as a reduction in the cost basis of the security. The amount of the other-than-temporary impairment on debt securities related to other factors is recorded consistent with changes in the fair value of all other available-for-sale securities as a component of consolidated shareholders' equity in other comprehensive income or loss with no change to the cost basis of the security.

### **Interest Income Recognition**

Interest income on available-for-sale MBS, which includes accretion of discounts and amortization of premiums on such MBS, is recognized over the life of the investment using the effective interest method.

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Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on these estimated cash flows and the Company's purchase price. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate and interest rate fluctuations. In addition, management must use its judgment to estimate interest payment shortfalls due to delinquencies on the underlying mortgage loans. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management's estimates and its interest income. Security transactions are recorded on the trade date. Realized gains and losses from security transactions are determined based upon the specific identification method and recorded as gain (loss) on sale of available-for-sale securities in the consolidated statement of operations.

### **Investments in Unconsolidated Ventures**

The Company has investments in unconsolidated ventures. In circumstances where the Company has a non-controlling interest but is deemed to be able to exert significant influence over the affairs of the enterprise the Company utilizes the equity method of accounting. Under the equity method of accounting, the initial investment is increased each period for additional capital contributions and a proportionate share of the entity's earnings and decreased for cash distributions and a proportionate share of the entity's losses.

The Company elected the fair value option for its investments in unconsolidated ventures. The election for investments in unconsolidated ventures was made upon their initial recognition in the financial statements. The Company has elected the fair value option for the investments in unconsolidated ventures for the purpose of enhancing the transparency of its financial condition.

The Company measures the fair value of the investments in unconsolidated ventures on the basis of the net asset value per share of the investments as permitted in guidance effective for the interim and annual periods ended after December 15, 2009.

### **Dividends and Distributions Payable**

Dividends and distributions payable represent dividends declared at the balance sheet date which are payable to common shareholders and distributions declared at the balance sheet date which are payable to non-controlling interest common unit holders of the Operating Partnership, respectively.

### **Earnings per Share**

The Company calculates basic earnings per share by dividing net income for the period by weighted-average shares of the Company's common stock outstanding for that period. Diluted earnings per share takes into account the effect of dilutive instruments, such as units of limited partnership interest in the Operating Partnership ( OP Units ), and unvested restricted stock, but use the average share price for the period in determining the number of incremental shares that are to be added to the weighted-average number of shares outstanding.

### **Comprehensive Income (Loss)**

Comprehensive income is comprised of net income, as presented in the consolidated statements of operations, adjusted for changes in unrealized gains or losses on available for sale securities and changes in the fair value of derivatives accounted for as cash flow hedges.

### **Accounting for Derivative Financial Instruments**

U.S. GAAP provides disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (i) how and why an entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for; and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. U.S. GAAP requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.



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The Company records all derivatives on the balance sheet 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 designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts, such as credit default swaps, that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting under U.S. GAAP.

**Income Taxes**

The Company elected to be taxed as a REIT, commencing with the Company's taxable year ended December 31, 2009. Accordingly, the Company will generally not be subject to U.S. federal and applicable state and local corporate income tax to the extent that the Company makes qualifying distributions to its shareholders, and provided 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, it 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 Company's failure to qualify as a REIT could have a material adverse impact on its results of operations and amounts available for distribution to its shareholders.

A REIT's dividend paid deduction for qualifying dividends to the Company's shareholders is computed using its taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income reported on the consolidated financial statements because the determination of taxable income is based on tax regulations and not financial accounting principles.

The Company may elect to treat certain of its future 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.

While a TRS will generate net income, a TRS can declare dividends to the Company which will be included in its taxable income and necessitate a distribution to its shareholders. Conversely, if the Company retains earnings at a TRS level, no distribution is required and the Company can increase book equity of the consolidated entity. The Company has no adjustments regarding its tax accounting treatment of any uncertainties. The Company expects to recognize interest and penalties related to uncertain tax positions, if any, as income tax expense, which will be included in general and administrative expense.

**Share-Based Compensation**

The Company has adopted an equity incentive plan under which its independent directors, as part of their compensation for serving as directors, are eligible to receive quarterly restricted stock awards. In addition, the Company may compensate the officers and employees of the Manager and its affiliates under this plan pursuant to the management agreement.

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Share-based compensation arrangements include share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Compensation costs relating to share-based payment transactions are recognized in the consolidated financial statements, based on the fair value of the equity or liability instruments issued on the date of grant, for awards to the Company's independent directors. Compensation related to stock awards to officers and employees of the Manager and its affiliates are recorded at the estimated fair value of the award during the vesting period. The Company makes an upward or downward adjustment to compensation expense for the difference in the fair value at the date of grant and the date the award was earned.

### **Dividend Reinvestment Plan**

The Company has implemented a dividend reinvestment and stock purchase plan (the Plan). Under the terms of the Plan, shareholders who participate in the Plan may purchase shares of common stock directly from the Company. Plan participants may also automatically reinvest all or a portion of their dividends for additional shares of stock.

### **Reclassifications**

The presentation of certain prior period reported amounts has been reclassified to be consistent with the current presentation. Such reclassifications had no impact on net income or equity attributable to common shareholders.

### **Recent Accounting Pronouncements**

In January 2010, the FASB issued Accounting Standards Update 2010-06, *Improving Disclosures about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 amends Topic 820 to require a number of additional disclosures regarding fair value measurements. Specifically, ASU 2010-06 requires entities to disclose: (1) the amount of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers; (2) the reasons for any transfers in or out of Level 3; and (3) information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. ASU 2010-06 also clarifies existing fair value disclosures about the appropriate level of disaggregation and about inputs and valuation techniques for both recurring and nonrecurring fair value measurements that fall in either Level 2 or Level 3. The new disclosures and clarifications of existing disclosures were effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The additional disclosure requirements were incorporated into Note 7, *Financial Instruments*.

In June 2011, the FASB issued Accounting Standards Update 2011-05, *Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 amends Topic 220 and eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity, and also requires presentation of reclassification adjustments from other comprehensive income to net income on the face of the financial statements. This guidance is effective for fiscal years and interim periods beginning after December 15, 2011. On December 23, 2011, the FASB issued Accounting Standards Updated 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Updated No. 2011-05* (ASU 2011-12). ASU 2011-12 amends and defers changes in Update 2011-05 that relates to the presentation on the face of the financial statement of the reclassification adjustments out of accumulated other comprehensive income for all periods presented. The Company early adopted ASU 2011-05.

### **Recent Accounting Pronouncements Not Yet Adopted**

In April 2011, the FASB issued Accounting Standards Update 2011-03, *Reconsideration of Effective Control for Repurchase Agreements* (ASU 2011-03). ASU 2011-03 simplifies the accounting for financial assets transferred under repurchase agreements (repos) and similar arrangements, by eliminating the transferor's ability criterion from the assessment of effective control over those assets. This guidance is effective for fiscal years and interim periods beginning after December 15, 2011. The Company does not believe that the adoption of the amended guidance will have a significant effect on its consolidated financial statements.



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In May 2011, the FASB issued Accounting Standards Update 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS (ASU 2011-04). ASU 2011-04 amends Topic 820 and does not modify the requirements for when fair value measurements apply; rather, it clarifies the Board's intent about the application of existing fair value measurement requirements, and changes to a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. For public entities, this guidance is effective for fiscal years and interim periods beginning after December 15, 2011. Early application by public entities is not permitted. The Company does not believe that the adoption of the amended guidance will have a significant effect on its consolidated financial statements.

In December 2011, the FASB issued Accounting Standards Updated 2011-11, Disclosures about Offsetting Assets and Liabilities (ASU 2011-11). ASU 2011-11 amends Topic 210 to require additional disclosure information about offsetting and related arrangements. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transaction subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on a basis of US GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards (IFRS). The guidance is effective for periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company does not believe that the adoption of the amended guidance will have a significant effect on its consolidated financial statements.

**Note 3 Mortgage-Backed Securities**

All of the Company's MBS are classified as available-for-sale and, as such, are reported at fair value, which is determined by obtaining valuations from an independent source. If the fair value of a security is not available from a dealer or third-party pricing service, or such data appears unreliable, the Company may estimate the fair value of the security using a variety of methods including other pricing services, repurchase agreement pricing, discounted cash flow analysis, matrix pricing, option adjusted spread models and other fundamental analysis of observable market factors. At December 31, 2011 and 2010, all of the Company's MBS values were based on values obtained from third-party pricing services. The following tables present certain information about the Company's investment portfolio at December 31, 2011 and 2010.

**December 31, 2011**

| \$ in thousands                | Principal<br>Balance | Unamortized<br>Premium<br>(Discount) | Amortized<br>Cost | Unrealized<br>Gain/<br>(Loss), net | Fair<br>Value     | Net<br>Weighted<br>Average<br>Coupon <sup>(1)</sup> | Average<br>Yield <sup>(2)</sup> |
|--------------------------------|----------------------|--------------------------------------|-------------------|------------------------------------|-------------------|---|---------------------------------|
| <b>Agency RMBS:</b>            |                      |                                      |                   |                                    |                   |   |                                 |
| 15 year fixed-rate             | 2,289,495            | 123,610                              | 2,413,105         | 36,454                             | 2,449,559         | 4.18 %  | 2.85 %                          |
| 30 year fixed-rate             | 6,055,045            | 410,257                              | 6,465,302         | 116,309                            | 6,581,611         | 4.95 %  | 3.66 %                          |
| ARM                            | 113,413              | 2,398                                | 115,811           | 2,065                              | 117,876           | 3.40 %  | 3.07 %                          |
| Hybrid ARM                     | 1,321,339            | 30,516                               | 1,351,855         | 22,630                             | 1,374,485         | 3.29 %  | 2.59 %                          |
| <b>Total Agency</b>            | <b>9,779,292</b>     | <b>566,781</b>                       | <b>10,346,073</b> | <b>177,458</b>                     | <b>10,523,531</b> | <b>4.53 %</b>                                       | <b>3.33 %</b>                   |
| <b>MBS-CMO</b>                 | <b>765,172</b>       | <b>(592,342)</b>                     | <b>172,830</b>    | <b>(4,368)</b>                     | <b>168,462</b>    | <b>2.86 %</b>                                       | <b>3.52 %</b>                   |
| Non-Agency RMBS <sup>(3)</sup> | 2,719,797            | (252,135)                            | 2,467,662         | (108,434)                          | 2,359,228         | 4.57 %  | 5.07 %                          |
| CMBS                           | 1,250,607            | (21,805)                             | 1,228,802         | (65,874)                           | 1,162,928         | 5.38 %  | 5.60 %                          |
| <b>Total</b>                   | <b>14,514,868</b>    | <b>(299,501)</b>                     | <b>14,215,367</b> | <b>(1,218)</b>                     | <b>14,214,149</b> | <b>4.52 %</b>                                       | <b>3.83 %</b>                   |

(1) Net weighted average coupon ( WAC ) is presented net of servicing and other fees.

(2) Average yield incorporates future prepayment and loss assumptions.

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(3) The non-Agency RMBS held by the Company is 9.8% fixed rate, 5.2% floating rate and 85.0% variable rate based on fair value.

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December 31, 2010

| \$ in thousands                | Principal<br>Balance | Unamortized<br>Premium<br>(Discount) | Amortized<br>Cost | Unrealized<br>Gain/<br>(Loss), net | Fair<br>Value | Net<br>Weighted<br>Average<br>Coupon<br>(1) | Average<br>Yield<br>(2) |
|--------------------------------|----------------------|--------------------------------------|-------------------|------------------------------------|---------------|---|-------------------------|
| Agency RMBS:                   |                      |                                      |                   |                                    |               |   |                         |
| 15 year fixed-rate             | 1,789,891            | 99,611                               | 1,889,502         | (8,688)                            | 1,880,814     | 4.49 %                                      | 2.89 %                  |
| 30 year fixed-rate             | 2,059,475            | 163,332                              | 2,222,807         | 6,771                              | 2,229,578     | 5.54 %                                      | 3.57 %                  |
| ARM                            | 21,926               | 1,080                                | 23,006            | (494)                              | 22,512        | 4.23 %                                      | 2.55 %                  |
| Hybrid ARM                     | 70,253               | 1,612                                | 71,865            | 448                                | 72,313        | 3.68 %                                      | 2.71 %                  |
| Total Agency                   | 3,941,545            | 265,635                              | 4,207,180         | (1,963)                            | 4,205,217     | 5.03 %                                      | 3.25 %                  |
| MBS-CMO                        |                      |                                      |                   |                                    |               |   |                         |
| MBS-CMO                        | 57,232               | (30,248)                             | 26,984            | 1,821                              | 28,805        | 4.92 %                                      | 3.59 %                  |
| Non-Agency RMBS <sup>(3)</sup> | 1,168,797            | (339,501)                            | 829,296           | 17,072                             | 846,368       | 4.83 %                                      | 5.47 %                  |
| CMBS                           | 488,246              | (4,640)                              | 483,606           | 14,337                             | 497,943       | 5.35 %                                      | 5.51 %                  |
| Total                          | 5,655,820            | (108,754)                            | 5,547,066         | 31,267                             | 5,578,333     | 5.01 %                                      | 3.78 %                  |

(1) Net weighted average coupon ( WAC ) is presented net of servicing and other fees.

(2) Average yield incorporates future prepayment and loss assumptions.

(3) The non-Agency RMBS held by the Company is 14.3% fixed rate, 8.7% floating rate and 77.0% variable rate based on fair value.

The following table summarizes our non-Agency RMBS portfolio by asset type as of December 31, 2011 and December 31, 2010, respectively:

| \$ in thousands  | December 31, 2011 | % of Non-Agency | December 31, 2010 | % of Non-Agency |
|------------------|-------------------|-----------------|-------------------|-----------------|
| Re-REMIC Senior  | 1,634,376         | 69.3%           | -                 | -               |
| Prime            | 482,113           | 20.4%           | 516,723           | 61.1%           |
| Alt-A            | 231,936           | 9.8%            | 329,645           | 38.9%           |
| Subprime         | 10,803            | 0.5%            | -                 | -               |
| Total Non-Agency | 2,359,228         | 100.0%          | 846,368           | 100%            |

The components of the carrying value of the Company's investment portfolio at December 31, 2011 and 2010 are presented below.

| \$ in thousands         | December 31, 2011 | December 31, 2010 |
|-------------------------|-------------------|-------------------|
| Principal balance       | 14,514,868        | 5,655,820         |
| Unamortized premium     | 587,430           | 271,728           |
| Unamortized discount    | (886,931)         | (380,482)         |
| Gross unrealized gains  | 203,965           | 75,231            |
| Gross unrealized losses | (205,183)         | (43,964)          |

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|            |            |           |
|------------|------------|-----------|
| Fair value | 14,214,149 | 5,578,333 |
|------------|------------|-----------|

The following table summarizes certain characteristics of the Company's investment portfolio, at fair value, according to estimated weighted average life classifications as of December 31, 2011 and 2010:

| <b>\$ in thousands</b>                         | <b>December 31, 2011</b> | <b>December 31, 2010</b> |
|--|--------------------------|--------------------------|
| Less than one year                             | 68,217                   | 26,214                   |
| Greater than one year and less than five years | 12,150,472               | 3,304,668                |
| Greater than or equal to five years            | 1,995,460                | 2,247,451                |
| <br>Total                                      | <br>14,214,149           | <br>5,578,333            |

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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 December 31, 2011 and 2010, respectively:

| December 31, 2011      | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                        | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>\$ in thousands</b> |                     |                   |                   |                   |            |                   |
| Agency RMBS:           |                     |                   |                   |                   |            |                   |
| 15 year fixed-rate     | 149,092             | (754)             | -                 | -                 | 149,092    | (754)             |
| 30 year fixed-rate     | 844,272             | (5,563)           | -                 | -                 | 844,272    | (5,563)           |
| ARM                    | 25,508              | (179)             | 13,062            | (52)              | 38,570     | (231)             |
| Hybrid ARM             | 24,929              | (73)              | -                 | -                 | 24,929     | (73)              |
| Total Agency           | 1,043,801           | (6,569)           | 13,062            | (52)              | 1,056,863  | (6,621)           |
| MBS-CMO                | 50,084              | (8,362)           | -                 | -                 | 50,084     | (8,362)           |
| Non-Agency RMBS        | 1,981,046           | (104,813)         | 46,193            | (11,622)          | 2,027,239  | (116,435)         |
| CMBS                   | 796,965             | (73,765)          | -                 | -                 | 796,965    | (73,765)          |
| Total                  | 3,871,896           | (193,509)         | 59,255            | (11,674)          | 3,931,151  | (205,183)         |

| December 31, 2010      | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                        | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>\$ in thousands</b> |                     |                   |                   |                   |            |                   |
| Agency RMBS:           |                     |                   |                   |                   |            |                   |
| 15 year fixed-rate     | 1,039,444           | (17,284)          | -                 | -                 | 1,039,444  | (17,284)          |
| 30 year fixed-rate     | 802,118             | (10,885)          | -                 | -                 | 802,118    | (10,885)          |
| ARM                    | 14,911              | (251)             | 7,601             | (244)             | 22,512     | (495)             |
| Hybrid ARM             | 10,912              | (17)              | -                 | -                 | 10,912     | (17)              |
| Total Agency           | 1,867,385           | (28,437)          | 7,601             | (244)             | 1,874,986  | (28,681)          |
| MBS-CMO                | -                   | -                 | -                 | -                 | -          | -                 |
| Non-Agency RMBS        | 370,839             | (13,242)          | -                 | -                 | 370,839    | (13,242)          |
| CMBS                   | 138,037             | (2,041)           | -                 | -                 | 138,037    | (2,041)           |
| Total                  | 2,376,261           | (43,720)          | 7,601             | (244)             | 2,383,862  | (43,964)          |

Gross unrealized losses on the Company's Agency RMBS were \$6.6 million at December 31, 2011. Due to the inherent credit quality of Agency RMBS, the Company determined that at December 31, 2011, any unrealized losses on its Agency RMBS portfolio were temporary.

Gross unrealized losses on the Company's MBS-CMO, non-Agency RMBS, and CMBS were \$198.6 million at December 31, 2011. The Company does not consider these unrealized losses to be credit related, but rather due to non-credit related factors such as interest rates spreads, prepayment speeds, and market fluctuations. These investment securities are included in the Company's assessment for other-than-temporary impairment on at least a quarterly basis.

The following table presents the impact of the Company's MBS on its accumulated other comprehensive income for the years ended December 31, 2011, 2010, and 2009.

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Years Ended December 31,

| <b>\$ in thousands</b>  | <b>2011</b> | <b>2010</b> | <b>2009</b> |
|---|-------------|-------------|-------------|
| <b>Accumulated other comprehensive income from investment securities:</b> |             |             |             |
| Unrealized gain on MBS at beginning of period, net                        | 31,267      | 12,741      | -           |
| Unrealized gain (loss) on MBS, net  | (32,485)    | 18,526      | 12,741      |
| Balance at the end of period  | (1,218)     | 31,267      | 12,741      |

During the years ended December 31, 2011 and 2010 the Company reclassified \$7.5 million of net unrealized losses and \$1.8 million of net unrealized gains, respectively, from other comprehensive income into gain (loss) on sale of investments as a result of the Company selling certain investments.

The Company assesses its investment securities 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.

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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 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 that it is more likely than not that the Company can hold the security until recovery of its cost basis.

The following table presents the other-than-temporary impairments for the years ended December 31, 2011, 2010 and 2009.

|  | 000,000                         | 000,000     | 000,000     |
|--|---------------------------------|-------------|-------------|
|  | <b>Years Ended December 31,</b> |             |             |
|  | <b>2011</b>                     | <b>2010</b> | <b>2009</b> |
| <b><u>\$ in thousands</u></b>  |                                 |             |             |
| Credit related other-than-temporary impairments included in earnings                         | -                               | 510         | -           |
| Non-credit related other-than-temporary impairments recognized in other comprehensive income | -                               | -           | -           |
| <b>Total other-than-temporary impairment losses</b>  | <b>-</b>                        | <b>510</b>  | <b>-</b>    |

The following table presents a roll-forward of the credit loss component of other-than-temporary impairments for the years ended December 31, 2011, 2010 and 2009.

|  | 000,000                         | 000,000     | 000,000     |
|--|---------------------------------|-------------|-------------|
|  | <b>Years Ended December 31,</b> |             |             |
|  | <b>2011</b>                     | <b>2010</b> | <b>2009</b> |
| <b><u>\$ in thousands</u></b>  |                                 |             |             |
| Cumulative credit loss amount at the beginning of the period   | 510                             | -           | -           |
| Additions for credit losses for which other-than-temporary impairment had not been previously recognized | -                               | 510         | -           |
| Reductions for securities sold   | (510)                           | -           | -           |
| <b>Cumulative credit loss amount at end of period</b>  | <b>-</b>                        | <b>510</b>  | <b>-</b>    |

The following table presents components of interest income on the Company's Agency and non-Agency portfolio for the years ended December 31, 2011, 2010 and 2009.

**For the Year ended December 31, 2011**

|                               | <b>Coupon</b>   | <b>Net (Premium</b>           | <b>Interest</b> |
|-------------------------------|-----------------|-------------------------------|-----------------|
|                               | <b>Interest</b> | <b>Amortization)/Discount</b> | <b>Income</b>   |
|                               |                 | <b>Accretion</b>              |                 |
| <b><u>\$ in thousands</u></b> |                 |                               |                 |
| Agency                        | 344,447         | (85,566)                      | 258,881         |
| Non-Agency                    | 104,547         | 35,230                        | 139,777         |
| CMBS                          | 54,508          | 226                           | 54,734          |
| Other                         | (40)            | -                             | (40)            |
| <b>Total</b>                  | <b>503,462</b>  | <b>(50,110)</b>               | <b>453,352</b>  |

**For the Year ended December 31, 2010**

| <b>Coupon</b> | <b>Net (Premium</b>           | <b>Interest</b> |
|---------------|-------------------------------|-----------------|
|               | <b>Amortization)/Discount</b> |                 |

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| <u>\$ in thousands</u> | <b>Interest</b> | <b>Accretion</b> | <b>Income</b>  |
|------------------------|-----------------|------------------|----------------|
| Agency                 | 76,602          | (22,794)         | 53,808         |
| Non-Agency             | 38,250          | 29,851           | 68,101         |
| CMBS                   | 11,936          | 342              | 12,278         |
| Other                  | 42              | -                | 42             |
| <b>Total</b>           | <b>126,830</b>  | <b>7,399</b>     | <b>134,229</b> |



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| <b><u>\$ in thousands</u></b> | <b>Coupon<br/>Interest</b> | <b>Net (Premium<br/>Amortization)/Discount<br/>Accretion</b> | <b>Interest<br/>Income</b> |
|-------------------------------|----------------------------|--|----------------------------|
| Agency                        | 16,660                     | (3,835)  | 12,825                     |
| Non-Agency                    | 3,182                      | 5,333  | 8,515                      |
| CMBS                          | 1,894                      | 266  | 2,160                      |
| Other                         | 29                         | -  | 29                         |
| <b>Total</b>                  | <b>21,765</b>              | <b>1,764</b>   | <b>23,529</b>              |

**Note 4 Investments in Unconsolidated Ventures****Invesco Mortgage Recovery Feeder Fund, L.P. and Invesco Mortgage Recovery Loans AIV, L.P.**

The Company invested in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing equity capital to a legacy securities PPIF managed by the Manager, Invesco Mortgage Recovery Feeder Fund, L.P. (the Invesco IMRF Fund) that receives financing under the U.S. government's Public Private Investment Program ( PPIP ). In addition, the Manager identified a whole loan transaction for the Company, which resulted in the Company's admission into an alternative investment vehicle, the Invesco Mortgage Recovery Loans AIV, L.P. ( AIV ). The Company's initial commitment in the Invesco IMRF Fund and AIV was \$25.0 million. During 2009 and 2010, the Invesco IMRF Fund and AIV accepted additional subscriptions and the Company increased its overall commitment to \$100.0 million which effectively increased the Company's initial ownership interest in the Invesco IMRF Fund and AIV. As of March 31, 2010, the Invesco IMRF Fund stopped accepting investment subscriptions and was deemed closed. The Company made its first contributions to the Invesco IMRF Fund in October 2009. The Company is committed to fund approximately \$20.3 million in aggregate of additional capital at December 31, 2011 for the Invesco IMRF Fund and AIV. The Company realized approximately \$6.0 million (2010: \$4.8 million; 2009: \$63,000) of equity in earnings for the years ended December 31, 2011. The Company also realized \$3.8 million of unrealized loss and \$3.5 million and \$8,000 of unrealized gain from these investments for the year ended December 31, 2011, 2010 and 2009, respectively.

The Company's non-controlling, unconsolidated ownership interests in these entities are accounted for under the equity method. Capital contributions, distributions, profits and losses of the Invesco IMRF Fund and AIV are allocated in accordance with the terms of the entities limited partnership agreements. Such allocations may differ from the stated percentage interests, if any, as a result of preferred returns and allocation formulas as described in such agreements. The Company has made the fair value election for its investment in both unconsolidated ventures. The fair value measurement for the investment in unconsolidated ventures is based on the net asset value per share of the investment, or its equivalent.

**IMRF Loan Portfolio Member LLC**

On December 31, 2011, the Company invested in a portfolio of commercial mortgage loans by contributing \$16.9 million, net of distributions, of equity capital to IMRF Loan Portfolio Member LLC ( IMRF ), a limited partnership managed by AIV. IMRF acquired the mortgage portfolio on the same day. The Company has fully funded its commitment to IMRF. The Company recognized no income or loss in respect of its ownership interests in IMRF for the year ended December 31, 2011. The Company realized approximately \$759,000 of equity in earnings and \$325,000 of unrealized appreciation from these investments for the year ended December 31, 2011.

The Company's non-controlling, unconsolidated ownership interest in IMRF is accounted for under the equity method. Capital contributions, distributions, profits and losses of IMRF are allocated in accordance with the terms of the entity's operating agreement. Such allocations may differ from the stated percentage interests, if any, as a result of preferred returns and allocation formulas as described in the agreement. The Company has made the fair value election for its investment in IMRF. The fair value measurement for the investment in unconsolidated limited liability companies is based on the net asset value per share of the investment, or its equivalent.

**Table of Contents****Index to Financial Statements****Note 5 Borrowings****Repurchase Agreements**

The Company has entered into repurchase agreements to finance the majority of its portfolio of investments. The repurchase agreements bear interest at a contractually agreed rate. The repurchase obligations mature and typically reinvest every thirty days to one year and have a weighted average aggregate interest rate of 0.68% and 0.57% at 2011 and 2010, respectively. Repurchase agreements are being accounted for as secured borrowings since the Company maintains effective control of the financed assets. The following table summarizes certain characteristics of the Company's repurchase agreements at December 31, 2011 and 2010:

| <u>\$ in thousands</u> | December 31, 2011     |   | December 31, 2010     |   |
|------------------------|-----------------------|---|-----------------------|---|
|                        | Amount<br>Outstanding | Weighted<br>Average<br>Interest<br>Rate | Amount<br>Outstanding | Weighted<br>Average<br>Interest<br>Rate |
| Agency RMBS            | 9,491,538             | 0.38 %                                  | 3,483,440             | 0.33 %                                  |
| Non-Agency RBS         | 1,916,620             | 1.79 %                                  | 459,979               | 1.76 %                                  |
| CMBS                   | 844,880               | 1.55 %                                  | 401,240               | 1.30 %                                  |
| Total                  | 12,253,038            | 0.68 %                                  | 4,344,659             | 0.57 %                                  |

Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls. In addition, the repurchase agreements are subject to certain financial covenants. The Company is in compliance with these covenants at December 31, 2011.

The following tables summarize certain characteristics of the Company's repurchase agreements at December 31, 2011 and 2010:

**December 31, 2011**

| <u>\$ in thousands</u>   | Amount<br>Outstanding | Percent of Total      |                                      |
|--|-----------------------|-----------------------|--------------------------------------|
|  |                       | Amount<br>Outstanding | Company MBS<br>Held<br>as Collateral |
| <b>Repurchase Agreement Counterparties</b>                     |                       |                       |                                      |
| Credit Suisse Securities (USA) LLC                             | 2,419,546             | 19.8 %                | 2,738,101                            |
| Nomura Securities International, Inc.                          | 1,069,235             | 8.7 %                 | 1,152,957                            |
| Mitsubishi UFJ Securities (USA), Inc.                          | 925,863               | 7.6 %                 | 979,907                              |
| Industrial and Commercial Bank of China Financial Services LLC | 848,919               | 6.9 %                 | 895,760                              |
| South Street Securities LLC                                    | 772,637               | 6.3 %                 | 818,513                              |
| JP Morgan Securities Inc.                                      | 663,879               | 5.4 %                 | 764,972                              |
| Morgan Stanley & Co. Incorporated                              | 645,570               | 5.3 %                 | 710,729                              |
| Goldman, Sachs & Co.   | 606,922               | 5.0 %                 | 649,514                              |
| RBS Securities Inc.  | 593,051               | 4.8 %                 | 671,073                              |
| ING Financial Market LLC                                       | 537,122               | 4.4 %                 | 568,813                              |
| Deutsche Bank Securities Inc.                                  | 531,302               | 4.3 %                 | 579,659                              |
| Banc of America Securities LLC                                 | 455,954               | 3.7 %                 | 521,888                              |
| CitiGroup Global Markets Inc.                                  | 447,280               | 3.7 %                 | 476,511                              |
| Royal Bank of Canada   | 422,700               | 3.4 %                 | 482,988                              |
| Wells Fargo Securities, LLC                                    | 389,803               | 3.2 %                 | 479,926                              |
| BNP Paribas Securities Corp.                                   | 348,707               | 2.8 %                 | 372,876                              |
| Mizuho Securities USA Inc.                                     | 186,997               | 1.5 %                 | 206,594                              |
| Guggenheim Liquidity Services, LLC                             | 139,744               | 1.1 %                 | 147,786                              |
| Daiwa Capital Markets America Inc                              | 106,121               | 0.9 %                 | 113,695                              |
| UBS Securities Inc.  | 80,083                | 0.7 %                 | 84,561                               |
| Cantor Fitzgerald & Co.  | 61,603                | 0.5 %                 | 63,999                               |

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|       |            |         |            |
|-------|------------|---------|------------|
| Total | 12,253,038 | 100.0 % | 13,480,822 |
|-------|------------|---------|------------|

December 31, 2010

\$ in thousands

|  | Amount<br>Outstanding | Percent of<br>Total<br>Amount<br>Outstanding | Company<br>MBS<br>Held as<br>Collateral |
|--|-----------------------|--|---|
| <b>Repurchase Agreement Counterparties</b> |                       |  |   |
| Credit Suisse Securities (USA) LLC         | 974,369               | 22.4 %                                       | 1,072,719                               |
| Wells Fargo Securities, LLC                | 614,365               | 14.1 %                                       | 710,529                                 |
| Morgan Stanley & Co. Incorporated          | 468,748               | 10.8 %                                       | 511,022                                 |
| Deutsche Bank Securities Inc.              | 463,087               | 10.7 %                                       | 493,533                                 |
| Barclays Capital Inc.                      | 287,469               | 6.6 %  | 322,035                                 |
| Goldman, Sachs & Co.                       | 273,369               | 6.4 %  | 291,512                                 |
| Mitsubishi UFJ Securities (USA), Inc.      | 261,594               | 6.0 %  | 273,131                                 |
| BNP Paribas Securities Corp.               | 228,566               | 5.3 %  | 239,218                                 |
| JP Morgan Securities Inc.                  | 227,261               | 5.2 %  | 255,403                                 |
| RBS Securities Inc.                        | 210,332               | 4.8 %  | 241,331                                 |
| Banc of America Securities LLC             | 200,081               | 4.6 %  | 220,018                                 |
| Nomura Securities International, Inc.      | 135,418               | 3.1 %  | 144,586                                 |
| <b>Total</b>                               | <b>4,344,659</b>      | <b>100.0 %</b>                               | <b>4,775,037</b>                        |

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Company MBS held by counterparties as security for repurchase agreements was \$13.5 billion and \$4.8 billion at December 31, 2011 and 2010, respectively. This represents a collateral ratio (Company MBS Held as Collateral/Amount Outstanding) of 110% and 110% for 2011 and 2010, respectively.

Cash collateral held by the counterparties at December 31, 2011 and 2010 was \$37.5 million and \$81.3 million, respectively.

**Note 6 Derivatives and Hedging Activities****Risk Management Objective of Using Derivatives**

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its investments, debt funding, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's investments and borrowings.

The Company also utilizes credit derivatives such as credit default swaps ( CDS ) to provide credit event protection based on a financial index or specific security in exchange for receiving a fixed-rate fee or premium over the term of the contract. These instruments enable the Company to synthetically assume the credit risk of a reference security, portfolio of securities or index of securities. The counterparty pays a premium to the Company and the Company agrees to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event.

Although contract-specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the CDS's notional amount is recorded as a realized loss in the statement of operations.

Our only CDS contract was entered into on December 31, 2010 where the Company sold protection on a specific pool of non-Agency RMBS that exceed a specified loss limit of 25% for a stated fixed rate fee of 3%. The Company's maximum exposure is the unpaid principal balance of the underlying RMBS that exceeds the specified loss limit. The Company is required to post cash collateral to secure potential loss payments.

At December 31, 2011 and 2010, the open CDS sold by the Company is summarized as follows:

| <b>\$ in thousand</b>                                    | <b>December 31, 2011</b> | <b>December 31, 2010</b> |
|--|--------------------------|--------------------------|
| Fair value amount  | 1,339                    | -                        |
| Notional amount  | 112,128                  | 149,964                  |
| Maximum potential amount of future undiscounted payments | 112,128                  | 112,500                  |
| Recourse provisions with third parties                   | -                        | -                        |
| Collateral held by counterparty                          | 17,324                   | -                        |

**Table of Contents****Index to Financial Statements****Cash Flow Hedges of Interest Rate Risk**

The Company finances its activities primarily through repurchase agreements, which are generally settled on a short-term basis, usually from one to twelve months. At each settlement date, the Company refinances each repurchase agreement at the market interest rate at that time. Since the interest rate on its repurchase agreements change on a one to twelve month basis, the Company is exposed to changing interest rates. The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

During the year ended December 31, 2011, the Company recorded \$764,000 (2010: \$90,000) of unrealized swap losses in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company's swaps versus the refinancing dates of certain of its repurchase agreements.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest is accrued and paid on the Company's repurchase agreements. During the next twelve months, the Company estimates that an additional \$121.6 million will be reclassified as an increase to interest expense.

The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a maximum period of 113 months.

As of December 31, 2011, the Company had the following interest rate derivatives outstanding, that were designated as cash flow hedges of interest rate risk:

| Counterparty                          | Notional  | Fixed Interest Rate |             |
|---------------------------------------|-----------|---------------------|-------------|
|                                       |           | Maturity Date       | in Contract |
| The Bank of New York Mellon           | 175,000   | 8/5/2012            | 2.07%       |
| The Bank of New York Mellon           | 100,000   | 5/24/2013           | 1.83%       |
| The Bank of New York Mellon           | 200,000   | 6/15/2013           | 1.73%       |
| SunTrust Bank                         | 100,000   | 7/15/2014           | 2.79%       |
| Deutsche Bank AG                      | 200,000   | 1/15/2015           | 1.08%       |
| Deutsche Bank AG                      | 250,000   | 2/15/2015           | 1.14%       |
| Credit Suisse International           | 100,000   | 2/24/2015           | 3.26%       |
| Credit Suisse International           | 100,000   | 3/24/2015           | 2.76%       |
| Wells Fargo Bank, N.A.                | 100,000   | 7/15/2015           | 2.85%       |
| Wells Fargo Bank, N.A.                | 50,000    | 7/15/2015           | 2.44%       |
| Morgan Stanley Capital Services, Inc. | 300,000   | 1/24/2016           | 2.12%       |
| The Bank of New York Mellon           | 300,000   | 1/24/2016           | 2.13%       |
| Morgan Stanley Capital Services, Inc. | 300,000   | 4/5/2016            | 2.48%       |
| Citibank, N.A.                        | 300,000   | 4/15/2016           | 1.67%       |
| The Bank of New York Mellon           | 500,000   | 4/15/2016           | 2.24%       |
| Credit Suisse International           | 500,000   | 4/15/2016           | 2.27%       |
| JPMorgan Chase Bank, N.A.             | 500,000   | 5/16/2016           | 2.31%       |
| Goldman Sachs Bank USA                | 500,000   | 5/24/2016           | 2.34%       |
| Wells Fargo Bank, N.A.                | 250,000   | 6/15/2016           | 2.67%       |
| Goldman Sachs Bank USA                | 250,000   | 6/15/2016           | 2.67%       |
| JPMorgan Chase Bank, N.A.             | 500,000   | 6/24/2016           | 2.51%       |
| Citibank, N.A.                        | 500,000   | 10/15/2016          | 1.93%       |
| Deutsche Bank AG                      | 150,000   | 2/5/2018            | 2.90%       |
| Morgan Stanley Capital Services, Inc. | 100,000   | 4/5/2018            | 3.10%       |
| JPMorgan Chase Bank, N.A.             | 200,000   | 5/15/2018           | 2.93%       |
| Wells Fargo Bank, N.A.                | 200,000   | 3/15/2021           | 3.14%       |
| Citibank, N.A.                        | 200,000   | 5/25/2021           | 2.83%       |
| Total                                 | 6,925,000 |                     | 2.29%       |

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At December 31, 2011, the Company's counterparties held approximately \$19.7 million of cash margin deposits and approximately \$447.6 million in Agency RMBS as collateral against its swap contracts. The cash is classified as restricted cash and the Agency RMBS is included in the total mortgage-backed securities on our consolidated balance sheet.

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**Tabular Disclosure of the Effect of Derivative Instruments on the Balance Sheet**

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the balance sheet as of December 31, 2011 and 2010.

**\$ in thousands**

| Asset Derivatives        |            |                          |            | Liability Derivatives        |            |                              |            |
|--------------------------|------------|--------------------------|------------|------------------------------|------------|------------------------------|------------|
| As of December 31, 2011  |            | As of December 31, 2010  |            | As of December 31, 2011      |            | As of December 31, 2010      |            |
| Balance Sheet            | Fair Value | Balance Sheet            | Fair Value | Balance Sheet                | Fair Value | Balance Sheet                | Fair Value |
| Interest rate swap asset | -          | Interest rate swap asset | 33,255     | Interest rate swap liability | 396,780    | Interest rate swap liability | 37,850     |
| CDS                      | 1,339      |                          |            |                              |            |                              |            |

**Tabular Disclosure of the Effect of Derivative Instruments on the Income Statement**

The table below presents the effect of the Company's derivative financial instruments on the statement of operations for the years ended December 31, 2011, 2010 and 2009.

Year ended December 31, 2011

| \$ in thousands                     |  | Location of loss reclassified from accumulated OCI into |  | Location of loss recognized in             |   |
|-------------------------------------|--|---|--|--|---|
| Derivative type for cash flow hedge | Amount of loss recognized in OCI on derivative (effective portion) | income (effective portion)                              | Amount of loss reclassified from accumulated OCI into income (effective portion) | income on derivative (ineffective portion) | Amount of loss recognized in income on derivative (ineffective portion) |
| Interest Rate Swap                  | 494,053  | Interest Expense  | 102,632  | Other Expense                              | 764   |

Year ended December 31, 2010

| \$ in thousands                     |  | Location of loss reclassified from accumulated OCI into |  | Location of loss recognized in             |   |
|-------------------------------------|--|---|--|--|---|
| Derivative type for cash flow hedge | Amount of loss recognized in OCI on derivative (effective portion) | income (effective portion)                              | Amount of loss reclassified from accumulated OCI into income (effective portion) | income on derivative (ineffective portion) | Amount of loss recognized in income on derivative (ineffective portion) |
| Interest Rate Swap                  | 15,252   | Interest Expense  | 14,529   | Other Expense                              | 90  |

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Year ended December 31, 2009

\$ in thousands

| Derivative<br>type for<br>cash flow<br>hedge | Amount of loss recognized<br>in OCI on<br>derivative<br>(effective<br>portion) | Location of loss<br>reclassified from<br>accumulated<br>OCI into<br>income<br>(effective<br>portion) | Amount of<br>loss<br>reclassified<br>from<br>accumulated OCI into<br>income<br>(effective<br>portion) | Location of loss<br>recognized in<br>income on<br>derivative<br>(ineffective<br>portion) | Amount of<br>loss<br>recognized in income<br>on<br>derivative<br>(ineffective<br>portion) |
|--|--|--|---|--|---|
| Interest Rate Swap                           | 6,420  | Interest Expense   | 2,638   | Other Expense  | -   |

| Derivative<br>not designated as<br>hedging instrument | Location of unrealized gain<br>recognized in income<br>on derivative | Amount of gain recognized in income on derivative<br>Year ended months ended<br>December 31, 2011 | Year ended months ended<br>December 31,<br>2010 |
|---|--|---|---|
| CDS Contract  | Realized and unrealized credit default swap income                   | 1,339   | -   |



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**Credit-risk-related Contingent Features**

The Company has agreements with each of its derivative counterparties. Some of those agreements contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

The Company has an agreement with one of its derivative counterparties that contains a provision where if the Company's net asset value declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations. The Company also has an agreement with one of its derivative counterparties that contains a provision where if the Company's shareholders' equity declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations.

The Company has an agreement with one of its derivative counterparties that contain a provision where if the Company fails to maintain a minimum shareholders' equity or market value of \$100 million and \$80 million, respectively, then the Company could be declared in default on its derivative obligations.

As of December 31, 2011, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for non-performance risk, related to these agreements was \$402.3 million. The Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of approximately \$19.7 million of cash and \$447.6 million of Agency RMBS at December 31, 2011. If the Company had breached any of these provisions at December 31, 2011, it could have been required to settle its obligations under the agreements at their termination value.

The Company was in compliance with all of the financial provisions of these agreements through December 31, 2011.

**Note 7 Financial Instruments**

U.S. GAAP defines fair value, provides a consistent framework for measuring fair value under U.S. GAAP and Accounting Standards Codification (ASC) Topic 820 expands fair value financial statement disclosure requirements. ASC Topic 820 does not require any new fair value measurements and only applies to accounting pronouncements that already require or permit fair value measures, except for standards that relate to share-based payments.

Valuation techniques are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from independent sources, while unobservable inputs reflect the Company's market assumptions. The three levels are defined as follows:

*Level 1 Inputs* Quoted prices for identical instruments in active markets.

*Level 2 Inputs* Quoted prices for similar instruments 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 3 Inputs* Instruments with primarily unobservable value drivers.

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The fair values on a recurring basis of the Company's MBS and interest rate hedges based on the level of inputs at December 31, 2011 and 2010 are summarized below:

| \$ in thousands                        | December 31, 2011<br>Fair Value Measurements Using: |                   |               | Total at<br>Fair Value |
|--|---|-------------------|---------------|------------------------|
|  | Level 1   | Level 2           | Level 3       |                        |
| <b>Assets</b>                          |   |                   |               |                        |
| Mortgage-backed securities(1)          | -   | 14,214,149        | -             | 14,214,149             |
| Investments in unconsolidated ventures | -   | -                 | 68,793        | 68,793                 |
| Derivatives                            | -   | -                 | 1,339         | 1,339                  |
| <b>Total</b>                           | <b>-</b>  | <b>14,214,149</b> | <b>70,132</b> | <b>14,284,281</b>      |
| <b>Liabilities</b>                     |   |                   |               |                        |
| Derivatives                            | -   | 396,780           | -             | 396,780                |
| <b>Total</b>                           | <b>-</b>  | <b>396,780</b>    | <b>-</b>      | <b>396,780</b>         |

| \$ in thousands                        | December 31, 2010<br>Fair Value Measurements Using: |                  |               | Total at<br>Fair Value |
|--|---|------------------|---------------|------------------------|
|  | Level 1   | Level 2          | Level 3       |                        |
| <b>Assets</b>                          |   |                  |               |                        |
| Mortgage-backed securities(1)          | -   | 5,578,333        | -             | 5,578,333              |
| Investments in unconsolidated ventures | -   | -                | 54,725        | 54,725                 |
| Derivatives                            | -   | 33,255           | -             | 33,255                 |
| <b>Total</b>                           | <b>-</b>  | <b>5,611,588</b> | <b>54,725</b> | <b>5,666,313</b>       |
| <b>Liabilities</b>                     |   |                  |               |                        |
| Derivatives                            | -   | 37,850           | -             | 37,850                 |
| <b>Total</b>                           | <b>-</b>  | <b>37,850</b>    | <b>-</b>      | <b>37,850</b>          |

(1) For more detail about the fair value of our MBS and type of securities, see Note 3 in the consolidated financial statements.

The following table presents additional information about the Company's investments in unconsolidated ventures which are measured at fair value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value:

| \$ in thousands   | December 31, 2011 | December 31, 2010 |
|-------------------|-------------------|-------------------|
| Beginning balance | 54,725            | 4,128             |
| Purchases         | 74,365            | 56,357            |

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|  |          |          |
|--|----------|----------|
| Sales and settlements  | (63,598) | (14,036) |
| Total net gains / (losses) included in net income                    |          |          |
| Realized gains/(losses), net   | 6,760    | 4,780    |
| Unrealized gains/(losses), net                                       | (3,459)  | 3,496    |
| Unrealized gain/(losses), net included in other comprehensive income | -        | -        |
| Ending balance   | 68,793   | 54,725   |

The following table presents additional information about the Company's CDS contract which is measured at fair value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value:

| <b>\$ in thousands</b>   | <b>December 31, 2011</b> | <b>December 31, 2010</b> |
|--|--------------------------|--------------------------|
| Beginning balance  | -                        | -                        |
| Purchases  | -                        | -                        |
| Sales and settlements  | -                        | -                        |
| Total net gains / (losses) included in net income                    |                          |                          |
| Realized gains/(losses), net   | -                        | -                        |
| Unrealized gains/(losses), net                                       | 1,339                    | -                        |
| Unrealized gain/(losses), net included in other comprehensive income | -                        | -                        |
| Ending balance   | 1,339                    | -                        |

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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 reflect current market interest rates that would be offered for loans with similar characteristics and credit quality. At December 31, 2011 the Company's repurchase agreements had a fair value of \$12.3 billion (2010: \$4.3 billion) and a carrying value of \$12.3 billion (2010: \$4.3 billion).

**Note 8 Related Party Transactions**

The Company is externally managed and advised by the Manager. Pursuant to the terms of the management agreement, the Manager and its affiliates provides the Company with its management team, including its officers, along with appropriate support personnel. Each of the Company's officers is an employee of Invesco or one of Invesco's affiliates. The Company does not have any employees. With the exception of the Company's Chief Financial Officer and Controller, the Manager is not obligated to dedicate any of its employees exclusively to the Company, nor is the Manager or its employees obligated to dedicate any specific portion of its or their time to the Company's business. The Manager is at all times subject to the supervision and oversight of the Company's board of directors and has only such functions and authority as the Company delegates to it.

**Management Fee**

The Company pays the Manager a management fee equal to 1.50% of the Company's shareholders' equity per annum, which is calculated and payable quarterly in arrears. For purposes of calculating the management fee, shareholders' equity is equal to the sum of the net proceeds from all issuances of 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 at the end of the most recently completed calendar quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid to repurchase common stock since inception, and excluding any unrealized gains, losses or other items that do not affect realized net income (regardless of whether such items are included in other comprehensive income or loss, or in net income). This amount will be adjusted to exclude one-time events pursuant to changes in U.S. GAAP, and certain non-cash items after discussions between the Manager and the Company's independent directors and approval by a majority of the Company's independent directors.

The Manager has agreed to reduce (but not below zero) the management fee payable by the Company under the management agreement with respect to any equity investment managed by the Manager. The fee reduction occurs at the equity investment level.

For the year ended December 31, 2011, the Company incurred management fees of approximately \$26.3 million (2010: \$8.1 million; 2009: \$1.5 million) of which \$8.6 million (2010: \$3.0 million; 2009: \$756,000) was accrued but has not been paid.

**Expense Reimbursement**

Pursuant to the management agreement, the Company is required to reimburse the Manager for operating expenses related to the Company incurred by the Manager, including directors and officers insurance, accounting services, auditing and tax services, filing fees, and miscellaneous general and administrative costs. The Company's reimbursement obligation is not subject to any dollar limitation.

For the year ended December 31, 2011, the company incurred costs, originally paid by Invesco, of approximately \$5.3 million (2010: \$3.8 million; 2009: \$1.1 million). Approximately \$4.3 million (2010: \$2.7 million; 2009: \$366,000) was expensed for the year ended December 31, 2011. Approximately \$969,000 (2010: \$1.1 million; 2009: \$660,000) was charged against equity as a cost of raising capital for the year ended December 31, 2011.

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**Termination Fee**

A termination fee is due to the Manager upon termination of the management agreement by the Company equal to three times the sum of the average annual management fee earned by the Manager during the 24-month period prior to such termination, calculated as of the end of the most recently completed fiscal quarter.

**Note 9 Shareholders Equity**

**Securities Convertible into Shares of Common Stock**

The limited partner who holds units of the Operating Partnership ( OP Units ) has the right to cause the Operating Partnership to redeem their OP Units for cash equal to the market value of an equivalent number of shares of common stock, or at the Company s option, the Company may purchase their OP Units by issuing one share of common stock for each OP Unit redeemed. The Company has also adopted an equity incentive plan which includes the ability of the Company to grant securities convertible into the Company s common stock to the independent directors and the executive officers of the Company and the personnel of the Manager and its affiliates.

**Registration Rights**

The Company entered into a registration rights agreement with regard to the common stock and OP Units owned by the Manager and Invesco Investments (Bermuda) Ltd., respectively, upon completion of the Company s IPO and any shares of common stock that the Manager may elect to receive under the management agreement or otherwise. Pursuant to the registration rights agreement, the Company has granted to the Manager and Invesco Investments (Bermuda) Ltd., (i) unlimited demand registration rights to have the shares purchased by the Manager or granted to it in the future and the shares that the Company may issue upon redemption of the OP Units purchased by Invesco Investments (Bermuda) Ltd. registered for resale, and (ii) in certain circumstances, the right to piggy-back these shares in registration statements the Company might file in connection with any future public offering so long as the Company retains the Manager under the management agreement.

**Public Offerings**

On March 25, 2011, the Company completed a follow-on common stock offering of 19,000,000 shares of common stock and an issuance of an additional 2,850,000 shares of common stock pursuant to the underwriters full exercise of their over-allotment option at \$21.07 per share. Net proceeds to the Company were \$460.1 million, net of issuance costs of approximately \$317,000.

On June 23, 2011, the Company completed a follow-on common stock offering of 17,000,000 shares of common stock and an issuance of an additional 2,550,000 shares of common stock pursuant to the underwriters full exercise of their over-allotment option at \$20.15 per share. Net proceeds to the Company were \$388.8 million, net of issuance costs of approximately \$5.1 million.

On August 23, 2011, the Company completed a follow-on common stock offering of 20,000,000 shares of common stock at \$18.37 per share. Net proceeds to the Company were \$362.3 million, net of issuance costs of approximately \$5.1 million.

During the year ended December 31, 2011, the Company issued 4,121,638 shares of common stock at an average price of \$20.93 under the share purchase feature of the Company s Dividend Reinvestment and Share Purchase Plan ( DRSP ) with total proceeds to the Company of approximately \$85.8 million, net of issuance costs.

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The Company established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to the independent directors and the executive officers of the Company and personnel of the Manager and its affiliates (the Incentive Plan). Under the Incentive Plan, a total of 1,000,000 shares of common stock are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. The Company recognized compensation expense of approximately \$143,000 (2010: \$105,000; 2009: \$38,000) for the year ended December 31, 2011. During the year ended December 31, 2011 the Company issued 7,053 (2010: 4,173; 2009: 912) shares of restricted stock pursuant to the Incentive Plan to the Company's non-executive directors. The fair market value of the shares granted was determined by the closing stock market price on the date of the grant.

The Company recognized compensation expense of approximately \$60,000 (2010: \$25,000; 2009: \$0) for the year ended December 31, 2011 related to awards to officers and employees of the Manager and its affiliates which is reimbursed by the Manager under the management agreement.

On March 17, 2011, the Company issued 896 shares of common stock (net of tax withholding) in exchange for 1,430 restricted stock units which vested under the Incentive Plan. The remaining restricted stock units awarded to the executive officers of the Company on March 17, 2010 were forfeited in March 2011.

**Dividends**

The following table sets forth the dividends declared per share of our common stock.

| Date Declared      | Dividends Declared Per Share |                  |
|--------------------|------------------------------|------------------|
|                    | Amount                       | Date of Payment  |
| <b><u>2011</u></b> |                              |                  |
| December 8, 2011   | \$0.65                       | January 27, 2012 |
| September 8, 2011  | \$0.80                       | October 27, 2011 |
| June 9, 2011       | \$0.97                       | July 28, 2011    |
| March 14, 2011     | \$1.00                       | April 27, 2011   |
| <b><u>2010</u></b> |                              |                  |
| December 14, 2010  | \$0.97                       | January 27, 2011 |
| September 20, 2010 | \$1.00                       | October 27, 2010 |
| June 21, 2010      | \$0.74                       | July 27, 2010    |
| March 17, 2010     | \$0.78                       | April 22, 2010   |

**Table of Contents****Index to Financial Statements****Note 10 Earnings per Share**

Earnings per share for the years ended December 31, 2011, 2010 and 2009 is computed as follows:

| \$ in thousands                               | Years Ended December 31, |         |        |
|---|--------------------------|---------|--------|
|   | 2011                     | 2010    | 2009   |
| <b>Numerator (Income)</b>                     |                          |         |        |
| Basic Earnings                                |                          |         |        |
| Net income available to common shareholders   | 281,915                  | 98,399  | 15,094 |
| Effect of dilutive securities:                |                          |         |        |
| Income allocated to non-controlling interest  | 4,882                    | 5,326   | 2,417  |
| Dilutive net income available to shareholders | 286,797                  | 103,725 | 17,511 |
| <b>Denominator (Weighted Average Shares)</b>  |                          |         |        |
| Basic Earnings:                               |                          |         |        |
| Shares available to common shareholders       | 86,365                   | 26,039  | 4,480  |
| Effect of dilutive securities:                |                          |         |        |
| Restricted Stock Awards                       | 14                       | 4       | -      |
| OP Units                                      | 1,425                    | 1,425   | 718    |
| Dilutive Shares                               | 87,804                   | 27,468  | 5,198  |

**Note 11 Non-controlling Interest - Operating Partnership**

Non-controlling interest represents the aggregate OP Units in the Operating Partnership held by limited partners (the Unit Holders). Income allocated to the non-controlling interest is based on the Unit Holders' ownership percentage of the Operating Partnership. The ownership percentage is determined by dividing the number of OP Units held by the Unit Holders by the total number of dilutive shares of common stock. The issuance of common stock ( Share or Shares ) or OP Units changes the percentage ownership of both the Unit Holders and the holders of common stock. Since an OP unit is generally redeemable for cash or Shares at the option of the Company, it is deemed to be equivalent to a Share. Therefore, such transactions are treated as capital transactions and result in an allocation between shareholders' equity and non-controlling interest in the accompanying consolidated balance sheet to account for the change in the ownership of the underlying equity in the Operating Partnership. As of December 31, 2011 and 2010, non-controlling interest related to the outstanding 1,425,000 OP Units represented a 1.2% and 2.8% interest in the Operating Partnership, respectively. Income allocated to the Operating Partnership non-controlling interest for the year ended December 31, 2011 was approximately \$4.9 million (2010: \$5.3 million; 2009: \$2.4 million). For the year ended December 31, 2011, distributions paid to the non-controlling interest were \$5.3 million (2010: \$5.1 million; 2009: \$0.9 million). As of December 31, 2011, distributions payable to the non-controlling interest were approximately \$0.9 million (2010: \$1.4 million; 2009: \$1.5 million).

**Note 12 - Summarized Quarterly (Unaudited)**

The following is a presentation of selected unaudited results of operations for the quarters ended:

| \$ in thousands, except per share data | Q411          | Q311          | Q211          | Q111          | Q410          | Q310          | Q210          | Q110          |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| <b>Revenues:</b>                       |               |               |               |               |               |               |               |               |
| Interest income                        | 137,545       | 138,291       | 108,980       | 68,536        | 50,945        | 36,067        | 29,207        | 18,010        |
| Interest expense                       | 55,004        | 50,452        | 34,207        | 15,578        | 10,652        | 8,873         | 6,379         | 3,652         |
| <b>Net interest income</b>             | <b>82,541</b> | <b>87,839</b> | <b>74,773</b> | <b>52,958</b> | <b>40,293</b> | <b>27,194</b> | <b>22,828</b> | <b>14,358</b> |

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|   |               |               |               |               |               |               |               |               |
|---|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| <b>Other income (loss)</b>  |               |               |               |               |               |               |               |               |
| Gain on sale of investments   | 2,517         | 3,637         | 3,605         | 1,200         | 2,392         | (311)         | 642           | 733           |
| Equity in earnings and fair value change in unconsolidated limited partnerships | 563           | (993)         | 1,873         | 1,858         | 2,388         | 3,793         | 1,649         | 446           |
| Loss on other-than-temporarily impaired securities                              | -             | -             | -             | -             | -             | (124)         | (262)         | (124)         |
| Unrealized loss on interest rate swaps  | (109)         | (453)         | (197)         | (5)           | (46)          | (9)           | (10)          | (25)          |
| Gain on credit default swap   | 659           | 858           | 1,259         | 2,532         | 13            | -             | -             | -             |
| <b>Total other income (loss)</b>  | <b>3,630</b>  | <b>3,049</b>  | <b>6,540</b>  | <b>5,585</b>  | <b>4,747</b>  | <b>3,349</b>  | <b>2,019</b>  | <b>1,030</b>  |
| <b>Expenses</b>   | <b>9,650</b>  | <b>8,714</b>  | <b>6,911</b>  | <b>4,843</b>  | <b>4,160</b>  | <b>2,924</b>  | <b>2,788</b>  | <b>2,221</b>  |
| <b>Net income</b>   | <b>76,521</b> | <b>82,174</b> | <b>74,402</b> | <b>53,700</b> | <b>40,880</b> | <b>27,619</b> | <b>22,059</b> | <b>13,167</b> |
| Net income attributable to non-controlling interest                             | 934           | 1,090         | 1,406         | 1,452         | 1,466         | 1,433         | 1,309         | 1,118         |
| <b>Net income attributable to common shareholders</b>                           | <b>75,587</b> | <b>81,084</b> | <b>72,996</b> | <b>52,248</b> | <b>39,414</b> | <b>26,186</b> | <b>20,750</b> | <b>12,049</b> |
| Earnings per share:   |               |               |               |               |               |               |               |               |
| Net income attributable to common shareholders (basic/diluted)                  | 0.66          | 0.79          | 0.99          | 1.01          | 1.00          | 1.01          | 0.91          | 0.77          |

NM = not meaningful



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**Note 13 Subsequent Events**

None noted.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**Invesco Mortgage Capital Inc.**

By: /s/ Richard J. King  
 Richard J. King  
 President and Chief Executive Officer  
 Date: February 29, 2012

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.

|     | <b>Signatures</b>            | <b>Title</b>                                    | <b>Date</b>       |
|-----|------------------------------|---|-------------------|
| By: | <u>/s/ Richard J. King</u>   | President and Chief Executive Officer           | February 29, 2012 |
|     | Richard J. King              | (principal executive officer)                   |                   |
| By: | <u>/s/ Donald R. Ramon</u>   | Chief Financial Officer                         | February 29, 2012 |
|     | Donald R. Ramon              | (principal financial and accounting<br>officer) |                   |
| By: | <u>/s/ G. Mark Armour</u>    | Director  | February 29, 2012 |
|     | G. Mark Armour               |   |                   |
| By: | <u>/s/ Karen Dunn Kelley</u> | Director  | February 29, 2012 |
|     | Karen Dunn Kelley            |   |                   |
| By: | <u>/s/ James S. Balloun</u>  | Director  | February 29, 2012 |
|     | James S. Balloun             |   |                   |
| By: | <u>/s/ John S. Day</u>       | Director  | February 29, 2012 |
|     | John S. Day                  |   |                   |
| By: | <u>/s/ Neil Williams</u>     | Director  | February 29, 2012 |
|     | Neil Williams                |   |                   |