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Two Harbors Investment Corp.
Form 10-Q
May 04, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended: March 31, 2012

Commission File Number 001-34506

TWO HARBORS INVESTMENT CORP.
(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| Maryland | 27-0312904 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

| | |
|--|------------|
| 601 Carlson Parkway, Suite 150 | 55305 |
| Minnetonka, Minnesota | (Zip Code) |
| (Address of Principal Executive Offices) | |
| (612) 629-2500 | |
| (Registrant's Telephone Number, Including Area Code) | |

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

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

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ 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 ☒
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of May 4, 2012 there were 214,217,304 shares of outstanding common stock, par value \$.01 per share, issued and outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TWO HARBORS INVESTMENT CORP.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (in thousands, except share data)

| | March 31, 2012 (unaudited) | December 31, 2011 |
|---|----------------------------------|----------------------|
| ASSETS | | |
| Available-for-sale securities, at fair value | \$9,171,511 | \$6,249,252 |
| Trading securities, at fair value | 1,002,090 | 1,003,301 |
| Mortgage loans held-for-sale, at fair value | 5,711 | 5,782 |
| Investment in real estate, net | 6,107 | — |
| Cash and cash equivalents | 545,688 | 360,016 |
| Restricted cash | 154,283 | 166,587 |
| Accrued interest receivable | 30,801 | 23,437 |
| Due from counterparties | 50,738 | 32,587 |
| Derivative assets, at fair value | 340,715 | 251,856 |
| Other assets | 23,338 | 7,566 |
| Total Assets | \$11,330,982 | \$8,100,384 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities | | |
| Repurchase agreements | \$8,693,756 | \$6,660,148 |
| Derivative liabilities, at fair value | 47,475 | 49,080 |
| Accrued interest payable | 9,314 | 6,456 |
| Due to counterparties | 413,086 | 45,565 |
| Accrued expenses | 9,495 | 8,912 |
| Dividends payable | 85,683 | 56,239 |
| Income taxes payable | — | 3,898 |
| Total liabilities | 9,258,809 | 6,830,298 |
| Stockholders' Equity | | |
| Preferred stock, par value \$0.01 per share; 50,000,000 shares authorized; no shares issued and outstanding | — | — |
| Common stock, par value \$0.01 per share; 450,000,000 shares authorized and 214,207,346 and 140,596,708 shares issued and outstanding, respectively | 2,142 | 1,406 |
| Additional paid-in capital | 2,064,423 | 1,373,099 |
| Accumulated other comprehensive income (loss) | 85,194 | (58,716) |
| Cumulative earnings | 209,252 | 157,452 |
| Cumulative distributions to stockholders | (288,838) | (203,155) |
| Total stockholders' equity | 2,072,173 | 1,270,086 |
| Total Liabilities and Stockholders' Equity | \$11,330,982 | \$8,100,384 |

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands, except share data)

| | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2012 | 2011 |
| | (unaudited) | |
| Interest income: | | |
| Available-for-sale securities | \$84,214 | \$19,535 |
| Trading securities | 1,050 | 272 |
| Mortgage loans held-for-sale | 69 | — |
| Cash and cash equivalents | 168 | 63 |
| Total interest income | 85,501 | 19,870 |
| Interest expense | 11,467 | 2,499 |
| Net interest income | 74,034 | 17,371 |
| Other-than-temporary impairments: | | |
| Total other-than temporary impairment losses | (4,275) |) — |
| Non-credit portion of loss recognized in other comprehensive income | — | — |
| Net other-than-temporary credit impairment losses | (4,275) |) — |
| Other income: | | |
| Gain on investment securities, net | 9,931 | 1,539 |
| (Loss) gain on interest rate swap and swaption agreements | (16,193) |) 1,939 |
| (Loss) gain on other derivative instruments | (8,890) |) 5,347 |
| Other loss | (40) |) — |
| Total other (loss) income | (15,192) |) 8,825 |
| Expenses: | | |
| Management fees | 6,743 | 1,550 |
| Other operating expenses | 3,601 | 1,512 |
| Total expenses | 10,344 | 3,062 |
| Income before income taxes | 44,223 | 23,134 |
| (Benefit from) provision for income taxes | (7,577) |) 757 |
| Net income attributable to common stockholders | \$51,800 | \$22,377 |
| Basic and diluted earnings per weighted average common share | \$0.28 | \$0.49 |
| Dividends declared per common share | \$0.40 | \$0.40 |
| Basic and diluted weighted average number of shares of common stock | 186,855,589 | 45,612,376 |
| Comprehensive income: | | |
| Net income | \$51,800 | \$22,377 |
| Other comprehensive income: | | |
| Unrealized gain on available-for-sale securities, net | 143,910 | 9,115 |
| Other comprehensive income | 143,910 | 9,115 |
| Comprehensive income | \$195,710 | \$31,492 |

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
(in thousands, except share data)

| | Common Stock | | | Accumulated | | Cumulative | Total |
|---|--------------|---------|----------------------------------|---|------------------------|-------------------------------------|-------------------------|
| | Shares | Amount | Additional Paid-in Capital | Other Comprehensive Income (Loss) (unaudited) | Cumulative Earnings | Distributions to Stockholders | Stockholders' Equity |
| Balance, January 1, 2011 | 40,501,212 | \$405 | \$366,974 | \$ 22,619 | \$ 30,020 | \$ (37,570) | \$ 382,448 |
| Net income | — | — | — | — | 22,377 | — | 22,377 |
| Other comprehensive income | — | — | — | 9,115 | — | — | 9,115 |
| Net proceeds from issuance of common stock, net of offering costs | 28,750,545 | 288 | 287,478 | — | — | — | 287,766 |
| Common dividends declared | — | — | — | — | — | (16,200) | (16,200) |
| Non-cash equity award compensation | — | — | 62 | — | — | — | 62 |
| Balance, March 31, 2011 | 69,251,757 | \$693 | \$654,514 | \$ 31,734 | \$52,397 | \$ (53,770) | \$ 685,568 |
| Balance, January 1, 2012 | 140,596,708 | \$1,406 | \$1,373,099 | \$ (58,716) | \$ 157,452 | \$ (203,155) | \$ 1,270,086 |
| Net income | — | — | — | — | 51,800 | — | 51,800 |
| Other comprehensive income | — | — | — | 143,910 | — | — | 143,910 |
| Net proceeds from issuance of common stock, net of offering costs | 73,610,638 | 736 | 691,264 | — | — | — | 692,000 |
| Common dividends declared | — | — | — | — | — | (85,683) | (85,683) |
| Non-cash equity award compensation | — | — | 60 | — | — | — | 60 |
| Balance, March 31, 2012 | 214,207,346 | \$2,142 | \$2,064,423 | \$ 85,194 | \$ 209,252 | \$ (288,838) | \$ 2,072,173 |

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

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TWO HARBORS INVESTMENT CORP.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (in thousands)

| | Three Months Ended March 31, | |
|---|---------------------------------|---------------|
| | 2012 | 2011 |
| | (unaudited) | |
| Cash Flows From Operating Activities: | | |
| Net income | \$51,800 | \$22,377 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Amortization of premiums and discounts on RMBS, net | (5,925) |) 2,467 |
| Other-than-temporary impairment losses | 4,275 | — |
| Gain on investment securities, net | (9,931) |) (1,539) |
| Loss (gain) on termination and option expiration of interest rate swaps and swaptions | 11,265 | (1,253) |
| Unrealized loss (gain) on interest rate swaps and swaptions | 212 | (3,838) |
| Unrealized loss (gain) on other derivative instruments | 8,026 | (1,971) |
| Unrealized loss on mortgage loans | 45 | — |
| Equity based compensation expense | 60 | 62 |
| Depreciation of real estate | 1 | — |
| Proceeds from repayment of mortgage loans held-for-sale | 26 | — |
| Net change in assets and liabilities: | | |
| Increase in accrued interest receivable | (7,364) |) (5,627) |
| Decrease in deferred income taxes, net | 638 | 482 |
| Increase in current tax receivable | (7,952) |) — |
| Decrease in prepaid and fixed assets | 38 | 204 |
| Increase in escrow deposits | (8,496) |) — |
| Increase in accrued interest payable, net | 2,858 | 520 |
| (Decrease)/increase in income taxes payable | (3,898) |) 275 |
| Increase in accrued expenses | 583 | 934 |
| Net cash provided by operating activities | 36,261 | 13,093 |
| Cash Flows From Investing Activities: | | |
| Purchases of available-for-sale securities | (3,065,659) |) (1,636,366) |
| Proceeds from sales of available-for-sale securities | 170,102 | 71,405 |
| Principal payments on available-for-sale securities | 130,002 | 44,659 |
| Purchases of other derivative instruments | (124,323) |) (70,302) |
| Proceeds from sales of other derivative instruments | 14,354 | 11,342 |
| Purchases of trading securities | — | (299,337) |
| Proceeds from sales of trading securities | — | 199,500 |
| Purchases of investments in real estate | (6,108) |) — |
| Increase in due to counterparties, net | 349,370 | 97,269 |
| Decrease (increase) in restricted cash | 12,304 | (16,443) |
| Net cash used in investing activities | (2,519,958) |) (1,598,273) |

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

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TWO HARBORS INVESTMENT CORP.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, continued
 (in thousands)

| | Three Months Ended March 31, | |
|---|---------------------------------|--------------|
| | 2012 | 2011 |
| | (unaudited) | |
| Cash Flows From Financing Activities: | | |
| Proceeds from repurchase agreements | \$ 10,564,948 | \$ 3,131,249 |
| Principal payments on repurchase agreements | (8,531,340) | (1,685,022) |
| Proceeds from issuance of common stock, net of offering costs | 692,000 | 287,766 |
| Dividends paid on common stock | (56,239) | (10,450) |
| Net cash provided by financing activities | 2,669,369 | 1,723,543 |
| Net increase in cash and cash equivalents | 185,672 | 138,363 |
| Cash and cash equivalents at beginning of period | 360,016 | 163,900 |
| Cash and cash equivalents at end of period | \$ 545,688 | \$ 302,263 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid for interest | \$ 8,609 | \$ 1,980 |
| Cash paid for taxes | \$ 3,635 | \$ 1 |
| Non-Cash Financing Activity: | | |
| Dividends declared but not paid at end of period | \$ 85,683 | \$ 16,200 |
| Reconciliation of mortgage loans held-for-sale: | | |
| Mortgage loans held-for-sale at beginning of period | \$ 5,782 | \$ — |
| Proceeds from repayment of mortgage loans held-for-sale | (26) | — |
| Unrealized loss on mortgage loans | (45) | — |
| Loans held-for-sale at end of period | \$ 5,711 | \$ — |

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

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 1. Organization and Operations

Two Harbors Investment Corp., or the Company, is a Maryland corporation focused on investing in, financing and managing residential mortgage-backed securities, or RMBS, residential mortgage loans, residential real properties, and other financial assets. The Company is externally managed and advised by PRCM Advisers LLC, a subsidiary of Pine River Capital Management L.P., or Pine River, a global multi-strategy asset management firm. The Company's common stock is listed on the NYSE and its warrants are listed on the NYSE Amex under the symbols "TWO" and "TWO.WS," respectively.

The Company has elected to be treated as a real estate investment trust, or REIT, for U.S. federal income tax purposes commencing with its initial taxable period ended December 31, 2009. As long as the Company continues to comply with a number of requirements under federal tax law and maintains its qualification as a REIT, the Company generally will not be subject to U.S. federal income taxes to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions. However, certain activities that the Company may perform may cause it to earn income which will not be qualifying income for REIT purposes. The Company has designated certain of its subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and the Company may in the future form additional TRSs.

Note 2. Basis of Presentation and Significant Accounting Policies

Consolidation and Basis of Presentation

The interim unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles, or GAAP, have been condensed or omitted according to such SEC rules and regulations. Management believes, however, that the disclosures included in these interim condensed consolidated financial statements are adequate to make the information presented not misleading. The accompanying condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at March 31, 2012 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2012 should not be construed as indicative of the results to be expected for the full year.

The condensed consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires us to make a number of significant estimates and assumptions. These estimates include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which the Company anticipates an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other estimates that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. The Company's estimates are inherently subjective in nature and actual results could differ from its estimates and the differences may be material.

The condensed consolidated financial statements of the Company include the accounts of all subsidiaries; inter-company accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

Significant Accounting Policies

Investment in Real Estate, Net

Beginning in early 2012, the Company began investing in single family residential properties with the intention of holding and renting the properties. Real estate is recorded at acquisition cost, allocated between land and building. Building depreciation is computed on the straight-line basis over the estimated useful lives of the assets. The Company generally uses a 27.5-year estimated life with no salvage value. For properties purchased subject to an existing lease, the assets are recorded at fair value, allocated to land, building and the existing lease. Any difference between fair value and cost is recorded in the income statement. The lease value is amortized over the expected benefit period (i.e., the lease term).

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

The Company evaluates its long-lived assets for impairment periodically or whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. If an impairment indicator exists, the Company compares the expected future undiscounted cash flows against the carrying amount of an asset. If the sum of the estimated undiscounted cash flows is less than the carrying amount of the asset, the Company would record an impairment loss for the difference between the estimated fair value and the carrying amount of the asset.

The lease periods are generally short term in nature (one year or less) and reflect market rental rates. Gross rental income and expenses applicable to rental income are reported in the statement of comprehensive income in other loss and other operating expenses, respectively. Expenditures for ordinary maintenance and repairs are expensed to operations as incurred and expenditures for significant renovations that improve the asset and extend the useful life of the asset are capitalized and depreciated over their estimated useful life.

Refer to Note 2 to the Consolidated Financial Statements in the Company's 2011 Annual Report on Form 10-K regarding additional significant accounting policies.

Recently Issued and/or Adopted Accounting Standards

Comprehensive Income

In June 2011, the Financial Accounting Standards Board, or FASB, issued ASU No. 2011-05, which amends ASC 820, Comprehensive Income. The amendments are intended to make the presentation of items within Other Comprehensive Income (OCI) more prominent. ASU 2011-05 eliminates the option to present components of OCI in the statement of changes in stockholders' equity and requires companies to present all non-owner changes in stockholders' equity either as a single continuous statement of comprehensive income or as two separate but consecutive statements. In addition, reclassification adjustments between OCI and net income must be presented separately on the face of the financial statements. The new guidance does not change the components of OCI or the calculation of earnings per share. ASU 2011-05 is effective for the first interim or annual period beginning on or after December 15, 2011. Adopting this ASU did not have a material impact on the Company's condensed consolidated financial condition or results of operations. On December 23, 2011, the FASB issued ASU 2011-12, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. This was done to allow the FASB time to re-deliberate whether to present on the face of the financial statements the effects of reclassification out of accumulated OCI on the components of net income and comprehensive income for all periods presented. No other requirements under ASU 2011-05 are affected by this update.

Fair Value

In May 2011, the FASB issued ASU No. 2011-04, which amends ASC 820, Fair Value Measurements. The amendments in this ASU clarify the requirements for measuring fair value and disclosing information about fair value. It is intended to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with GAAP and International Financial Reporting Standards, or IFRS. The ASU is effective for the first interim or annual period beginning on or after December 15, 2011. Adopting this ASU did not have a material impact on the Company's condensed consolidated financial condition or results of operations.

Offsetting Assets and Liabilities

In December 2011, the FASB issued ASU No. 2011-11, which amends ASC 210, Balance Sheet. The amendments in this ASU enhance disclosures required by U.S. GAAP by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with ASC 210, Balance Sheet or ASC 815, Other Presentation Matters or (2) subject to an enforceable master netting arrangement or similar agreement. ASU 2011-11 is effective for the first interim or annual period beginning on or after January 1, 2013. We anticipate that adopting this ASU will not have a material impact on the Company's condensed consolidated financial condition or results of operations.

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 3. Available-for-Sale Securities, at Fair Value

The following table presents the Company's available-for-sale, or AFS, investment securities by collateral type, which were carried at their fair value as of March 31, 2012 and December 31, 2011:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Mortgage-backed securities: | | |
| Agency | | |
| Federal Home Loan Mortgage Corporation | \$2,034,926 | \$1,609,003 |
| Federal National Mortgage Association | 3,801,065 | 2,414,637 |
| Government National Mortgage Association | 1,391,615 | 1,029,517 |
| Non-Agency | 1,943,905 | 1,196,095 |
| Total mortgage-backed securities | \$9,171,511 | \$6,249,252 |

At March 31, 2012 and December 31, 2011, the Company pledged investment securities with a carrying value of \$8.6 billion and \$6.2 billion, respectively, as collateral for repurchase agreements. See Note 12 - Repurchase Agreements. At March 31, 2012 and December 31, 2011, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, Transfers and Servicing, to be considered linked transactions and therefore classified as derivatives.

The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of March 31, 2012 and December 31, 2011:

| | March 31, 2012 | | |
|---------------------------|-------------------|-------------|--------------|
| (in thousands) | Agency | Non-Agency | Total |
| Face Value | \$7,722,200 | \$4,233,247 | \$11,955,447 |
| Unamortized premium | 458,949 | — | 458,949 |
| Unamortized discount | — | — | — |
| Designated credit reserve | — | (1,304,753) | (1,304,753) |
| Net, unamortized | (1,074,953) | (948,373) | (2,023,326) |
| Amortized Cost | 7,106,196 | 1,980,121 | 9,086,317 |
| Gross unrealized gains | 142,484 | 48,976 | 191,460 |
| Gross unrealized losses | (21,074) | (85,192) | (106,266) |
| Carrying Value | \$7,227,606 | \$1,943,905 | \$9,171,511 |
| | December 31, 2011 | | |
| (in thousands) | Agency | Non-Agency | Total |
| Face Value | \$5,692,754 | \$2,667,929 | \$8,360,683 |
| Unamortized premium | 279,640 | — | 279,640 |
| Unamortized discount | — | — | — |
| Designated credit reserve | — | (782,606) | (782,606) |
| Net, unamortized | (1,008,780) | (540,969) | (1,549,749) |
| Amortized Cost | 4,963,614 | 1,344,354 | 6,307,968 |
| Gross unrealized gains | 108,864 | 11,881 | 120,745 |
| Gross unrealized losses | (19,321) | (160,140) | (179,461) |
| Carrying Value | \$5,053,157 | \$1,196,095 | \$6,249,252 |

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

The following tables present the carrying value of the Company's AFS investment securities by rate type as of March 31, 2012 and December 31, 2011:

| | March 31, 2012 | | |
|-----------------|-------------------|-------------|-------------|
| (in thousands) | Agency | Non-Agency | Total |
| Adjustable Rate | \$227,164 | \$1,683,540 | \$1,910,704 |
| Fixed Rate | 7,000,442 | 260,365 | 7,260,807 |
| Total | \$7,227,606 | \$1,943,905 | \$9,171,511 |
| | December 31, 2011 | | |
| (in thousands) | Agency | Non-Agency | Total |
| Adjustable Rate | \$231,678 | \$995,014 | \$1,226,692 |
| Fixed Rate | 4,821,479 | 201,081 | 5,022,560 |
| Total | \$5,053,157 | \$1,196,095 | \$6,249,252 |

When the Company purchases a credit-sensitive AFS security at a significant discount to its face value, the Company often does not amortize into income a significant portion of this discount that the Company is entitled to earn because it does not expect to collect it due to the inherent credit risk of the security. The Company may also record an other-than-temporary impairment, or OTTI, for a portion of its investment in the security to the extent the Company believes that the amortized cost will exceed the present value of expected future cash flows. The amount of principal that the Company does not amortize into income is designated as an off balance sheet credit reserve on the security, with unamortized net discounts or premiums amortized into income over time to the extent realizable.

The following table presents the changes for the three months ended March 31, 2012 and 2011 of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

| | Three Months Ended March 31, 2012 | | | 2011 | | |
|--|-----------------------------------|--------------------------|----------------|---------------------------|--------------------------|--------------|
| (in thousands) | Designated Credit Reserve | Unamortized Net Discount | Total | Designated Credit Reserve | Unamortized Net Discount | Total |
| Beginning balance at January 1 | \$(782,606) | \$(540,969) | \$(1,323,575) | \$(145,855) | \$(129,992) | \$(275,847) |
| Acquisitions | (521,424) | (437,331) | (958,755) | (96,343) | (38,763) | (135,106) |
| Accretion of net discount | — | 28,897 | 28,897 | — | 5,376 | 5,376 |
| Realized credit losses | 3,309 | — | 3,309 | 771 | — | 771 |
| Reclassification adjustment for other-than-temporary impairments | (4,275) | — | (4,275) | — | — | — |
| Transfers from (to) | — | — | — | (123) | 123 | — |
| Sales, calls, other | 243 | 1,030 | 1,273 | 8,085 | 5,145 | 13,230 |
| Ending balance at March 31 | \$(1,304,753) | \$(948,373) | \$(2,253,126) | \$(233,465) | \$(158,111) | \$(391,576) |

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The following table presents the components comprising the carrying value of AFS securities not deemed to be other than temporarily impaired by length of time the securities had an unrealized loss position as of March 31, 2012 and December 31, 2011. At March 31, 2012, the Company held 1,074 AFS securities, of which 315 were in an unrealized loss position for less than twelve consecutive months and 41 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2011, the Company held 854 AFS securities, of which 264 were in an unrealized loss position for less than twelve months and 20 were in an unrealized loss position for more than twelve consecutive months.

| (in thousands) | Unrealized Loss Position for Less than 12 Months | | 12 Months or More | | Total | Gross Unrealized Losses |
|-------------------|---|-------------------------------|-------------------------|-------------------------------|-------------------------|-------------------------------|
| | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | |
| March 31, 2012 | \$2,893,328 | \$(89,623) | \$172,780 | \$(16,643) | \$3,066,108 | \$(106,266) |
| December 31, 2011 | \$1,277,120 | \$(175,348) | \$15,608 | \$(4,113) | \$1,292,728 | \$(179,461) |

Evaluating AFS Securities for Other-than-Temporary Impairments

In order to evaluate AFS securities for OTTI, the Company determines whether there has been a significant adverse quarterly change in the cash flow expectations for a security. The Company compares the amortized cost of each security in an unrealized loss position against the present value of expected future cash flows of the security. The Company also considers whether there has been a significant adverse change in the regulatory and/or economic environment as part of this analysis. If the amortized cost of the security is greater than the present value of expected future cash flows using the original yield as the discount rate, an other-than-temporary credit impairment has occurred. If the Company does not intend to sell and is not more likely than not required to sell the security, the credit loss is recognized in earnings and the balance of the unrealized loss is recognized in other comprehensive income. If the Company intends to sell the security or will be more likely than not required to sell the security, the full unrealized loss is recognized in earnings.

The Company recorded a \$4.3 million other-than-temporary credit impairment during three months ended March 31, 2012 on a total of fifteen non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost. As of March 31, 2012, the impaired securities had weighted average cumulative losses of 2.5%, weighted average three-month prepayment speed of 2.31, weighted average 60+ day delinquency of 37.5% of the pool balance, and weighted average FICO score of 650. At March 31, 2012 the Company did not intend to sell the securities and it is not more likely than not that the Company will be required to sell the securities, therefore, only the projected credit loss was recognized in earnings. The Company did not record an other-than-temporary credit impairment during the three months ended March 31, 2011.

The following table presents the OTTI included in earnings for three months ended March 31, 2012 and 2011:

| (in thousands) | Three Months Ended March 31, | |
|---|---------------------------------|------|
| | 2012 | 2011 |
| Cumulative credit loss at beginning of period | \$(5,102) | \$— |
| Additions: | | |
| Other-than-temporary impairments not previously recognized | (3,483) | — |
| Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments | (792) | — |
| Cumulative credit loss at end of period | \$(9,377) | \$— |

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains (losses) within gain on investment securities, net in the Company's condensed consolidated statements of comprehensive income. For the three months ended March 31, 2012, the Company sold AFS securities for \$170.1 million with an amortized cost of \$159.0 million, for a net

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realized gain of \$11.1 million. For the three months ended March 31, 2011, the Company sold AFS securities for \$71.4 million with an amortized cost of \$69.8 million, for a net realized gain of \$1.6 million.

The following table presents the gross realized gains and losses on sales of AFS securities for the three months ended March 31, 2012 and 2011:

| (in thousands) | Three Months Ended | |
|------------------------------------|--------------------|---------|
| | March 31, 2012 | 2011 |
| Gross realized gains | \$11,103 | \$1,808 |
| Gross realized losses | — | (170) |
| Total realized gains on sales, net | \$11,103 | \$1,638 |

Note 4. Trading Securities, at Fair Value

The Company holds U.S. Treasuries in its taxable REIT subsidiary and classifies these securities as trading instruments due to its short-term investment objectives. As of March 31, 2012 and December 31, 2011, the Company held U.S. Treasuries with an amortized cost of \$1.0 billion and a fair value of \$1.0 billion for both periods, classified as trading securities. The unrealized gains included within trading securities were \$1.9 million and \$3.1 million as of March 31, 2012 and December 31, 2011, respectively.

For the three months ended March 31, 2012, the Company did not sell any trading securities. For the three months ended March 31, 2011, the Company sold trading securities for \$199.5 million with an amortized cost of \$200.0 million, resulting in realized losses of \$0.5 million on the sale of these investment securities. For the three months ended March 31, 2012 and March 31, 2011, trading securities experienced unrealized losses of \$1.2 million and unrealized gains of \$0.4 million, respectively. Both realized and unrealized gains and losses are recorded as a component of gains on investment securities, net in the Company's condensed consolidated statements of comprehensive income.

At March 31, 2012, the Company pledged trading securities with a carrying value of \$1.0 billion as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.

Note 5. Mortgage Loans Held-for-Sale, at Fair Value

Mortgage loans held-for-sale consists of residential mortgage loans carried at fair value as a result of a fair value option election. The following table presents the carrying value of the Company's mortgage loans held-for-sale as of March 31, 2012 and December 31, 2011:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--------------------------|----------------|----------------------|
| Unpaid principal balance | \$5,629 | \$5,655 |
| Fair value adjustment | 82 | 127 |
| Carrying value | \$5,711 | \$5,782 |

At March 31, 2012, the Company pledged mortgage loans with a carrying value of \$5.7 million as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.

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Note 6. Investment in Real Estate, Net

Investments in real estate consists of single family residential properties purchased by the Company with the intention to hold and rent the properties. The following table presents the carrying value of the Company's investment in real estate as of March 31, 2012 and December 31, 2011:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--------------------------|----------------|-------------------|
| Land | \$ 1,191 | \$ — |
| Building | 4,917 | — |
| | 6,108 | — |
| Accumulated depreciation | (1 |) — |
| Carrying value | \$ 6,107 | \$ — |

Note 7. Restricted Cash

As of March 31, 2012 and December 31, 2011, the Company is required to maintain certain cash balances with counterparties for broker activity and collateral for the Company's repurchase agreements in non-interest bearing accounts.

The following table presents the Company's restricted cash balances:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--|----------------|-------------------|
| Restricted cash balances held by: | | |
| Broker counterparties for securities trading activity | \$9,000 | \$9,000 |
| Broker counterparties for derivatives trading activity | 99,103 | 62,784 |
| Repurchase counterparties as restricted collateral | 46,180 | 94,803 |
| Total | \$154,283 | \$166,587 |

Note 8. Accrued Interest Receivable

The following table presents the Company's accrued interest receivable by collateral type:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--|----------------|-------------------|
| Accrued Interest Receivable: | | |
| U.S. Treasuries | \$1,155 | \$1,003 |
| Mortgage-backed securities: | | |
| Agency | | |
| Federal Home Loan Mortgage Corporation | 7,203 | 5,844 |
| Federal National Mortgage Association | 13,830 | 9,770 |
| Government National Mortgage Association | 5,725 | 4,454 |
| Non-Agency | 2,854 | 2,328 |
| Total mortgage-backed securities | 29,612 | 22,396 |
| Mortgage loans held-for-sale | 34 | 38 |
| Total | \$30,801 | \$23,437 |

Note 9. Derivative Instruments and Hedging Activities

The Company enters into a variety of derivative and non-derivative instruments in connection with its risk management activities. The Company's primary objective for executing these derivatives and non-derivative instruments is to mitigate the Company's economic exposure to future events that are outside its control. The Company's derivative financial instruments are utilized principally to manage market risk and cash flow volatility

associated with interest rate risk (including associated prepayment risk) related to certain assets and liabilities. As part of its risk management activities, the Company may, at times, enter into various forward contracts including short securities, Agency to-be-announced securities, or TBAs, options, futures, swaps and caps. In executing on the Company's current risk management strategy, the Company has entered into interest rate swap and swaption agreements, TBA positions and credit default

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Notes to the Condensed Consolidated Financial Statements (unaudited)

swaps. The Company has also entered into a number of non-derivative instruments to manage interest rate risk, principally U.S. Treasuries and Agency interest-only securities.

The following summarizes the Company's significant asset and liability classes, the risk exposure for these classes, and the Company's risk management activities used to mitigate certain of these risks. The discussion includes both derivative and non-derivative instruments used as part of these risk management activities. While the Company uses non-derivative and derivative instruments to achieve the Company's risk management activities, it is possible that these instruments will not effectively mitigate all or a substantial portion of the Company's market rate risk. In addition, the Company might elect, at times, not to enter into certain hedging arrangements in order to maintain compliance with REIT requirements.

Balance Sheet Presentation

The following table presents the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading instruments as of March 31, 2012 and December 31, 2011.

| (in thousands) | March 31, 2012 | | | | December 31, 2011 | | | |
|----------------------------------|-------------------|-----------|------------------------|------------|-------------------|-----------|------------------------|------------|
| | Derivative Assets | | Derivative Liabilities | | Derivative Assets | | Derivative Liabilities | |
| Trading instruments | Fair Value | Notional | Fair Value | Notional | Fair Value | Notional | Fair Value | Notional |
| Inverse interest-only securities | \$246,066 | 1,666,707 | \$— | — | \$157,421 | 1,131,084 | \$— | — |
| Interest rate swap agreements | — | — | (34,540) |)7,035,000 | — | — | (28,790) |)5,810,000 |
| Credit default swap agreements | 62,924 | 541,426 | (9,802) |)111,450 | 86,136 | 544,699 | (14,638) |)154,812 |
| Swaptions | 30,214 | 4,300,000 | — | — | 5,635 | 2,900,000 | — | — |
| TBAs | 1,484 | 500,000 | (3,133) |)2,000,000 | 2,664 | 275,000 | (5,652) |)850,000 |
| Forward sale commitment | 27 | 5,178 | — | — | — | 5,202 | — | — |
| Total | \$340,715 | 7,013,311 | \$(47,475) |)9,146,450 | \$251,856 | 4,855,985 | \$(49,080) |)6,814,812 |

The following table provides the average outstanding notional amounts of the Company's derivative financial instruments treated as trading instruments for the three months ended March 31, 2012.

| (in thousands) | Three Months Ended March 31, 2012 | |
|----------------------------------|-----------------------------------|------------------------|
| Trading instruments | Derivative Assets | Derivative Liabilities |
| Inverse interest-only securities | 1,330,835 | — |
| Interest rate swap agreements | — | 6,366,593 |
| Credit default swaps | 541,888 | 137,567 |
| Swaptions | 3,573,077 | — |
| TBAs | 207,418 | 754,396 |
| Forward sale commitment | 5,186 | — |

Comprehensive Income Statement Presentation

The Company has not applied hedge accounting to its current derivative portfolio held to mitigate the interest rate risk associated with its debt portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.

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The following table summarizes the location and amount of gains and losses on derivative instruments reported in the condensed consolidated statement of comprehensive income on its derivative instruments:

(in thousands)

| Trading Instruments | Location of Gain/(Loss) Recognized in Income on Derivatives | Amount of Gain/(Loss) Recognized in Income on Derivatives Three Months Ended March 31, 20122011 | |
|--|--|--|-----------|
| Risk Management Instruments | | | |
| Interest Rate Contracts | | | |
| Investment securities - RMBS | (Loss) gain on other derivative instruments | \$(2,637 |) \$(258 |
| Investment securities - U.S. Treasuries and TBA contracts | (Loss) gain on interest rate swap and swaption agreements | (1,648 |) (410 |
| Mortgage loans held-for-sale | (Loss) gain on other derivative instruments | 13 | — |
| Repurchase agreements | (Loss) gain on interest rate swap and swaption agreements | (14,545 |) 2,349 |
| Credit default swaps - Receive protection | (Loss) gain on other derivative instruments | (24,301 |) — |
| Non-Risk Management Instruments | | | |
| Credit default swaps - Provide protection | (Loss) gain on other derivative instruments | 8,220 | 2,338 |
| Inverse interest-only securities | (Loss) gain on other derivative instruments | 9,815 | 3,267 |
| Total | | \$(25,083 |) \$7,286 |

For the three months ended March 31, 2012 and 2011, the Company recognized \$4.7 million and \$3.2 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The expenses result from generally paying a fixed interest rate on an average \$6.4 billion and \$1.3 billion notional, respectively, to hedge a portion of the Company's interest rate risk on its short-term repurchase agreements, funding costs, and macro-financing risk and generally receiving LIBOR interest.

For the three months ended March 31, 2012 and 2011, the Company terminated or had options expire on a total of 11 and 4 interest rate swap and swaption positions of \$0.9 billion notional and \$0.4 billion notional, respectively. Upon settlement of the early terminations and option expirations, the Company paid \$0.5 million and \$0.4 million in 2012 and 2011, respectively, in full settlement of its net interest spread liability and recognized \$11.3 million in realized losses and and \$1.3 million in realized gains on the swaps and swaptions in 2012 and 2011, respectively, including early termination penalties.

For the three months ended March 31, 2012, the Company terminated a total of 4 credit default swap positions totaling \$85.0 million notional. Upon settlement of the early terminations, the Company received \$10,492 in full settlement of its net interest spread receivable and recognized \$1.6 million in realized losses on the credit default swaps, including early termination penalties. The Company did not terminate any credit default swap positions during the three months ended March 31, 2011.

Cash flow activity related to derivative instruments is reflected within the operating activities and investing activities sections of the condensed consolidated statements of cash flows. Derivative fair value adjustments are reflected within the unrealized loss (gain) on interest rate swaps and swaptions and unrealized loss (gain) on other derivative instruments line items and realized losses on interest rate swap and swaption agreements are reflected within the loss

on termination of interest rate swaps and swaptions line item within the operating activities section of the condensed consolidated statements of cash flows. The remaining cash flow activity related to derivative instruments is reflected within the purchases of other derivative instruments, proceeds from sales of other derivative instruments and (decrease) increase in due to counterparties, net line items within the investing activities section of the condensed consolidated statements of cash flows.

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Interest Rate Sensitive Assets/Liabilities

Available-for-sale Securities - The Company's RMBS investment securities are generally subject to change in value when mortgage rates decline or increase, depending on the type of investment. Rising mortgage rates generally result in a slowing of refinancing activity, which slows prepayments and results in a decline in the value of the Company's fixed-rate Agency pools. To mitigate the impact of this risk, the Company maintains a portfolio of financial instruments, primarily fixed-rate interest-only securities, which increase in value when interest rates increase. In addition, the Company has initiated TBA positions to further mitigate its exposure to increased prepayment speeds. The objective is to reduce the risk of losses to the portfolio caused by interest rate changes and changes in prepayment speeds.

As of March 31, 2012 and December 31, 2011, the Company had outstanding fair value of \$60.6 million and \$48.4 million, respectively, of interest-only securities in place to economically hedge its investment securities. These interest-only securities are included in AFS securities, at fair value, in the condensed consolidated balance sheets. In addition, the Company held TBA positions with \$500.0 million and \$275.0 million in long notional and \$2.0 billion and \$850.0 million in short notional as of March 31, 2012 and December 31, 2011, respectively. The Company discloses these on a gross basis according to the unrealized gain or loss position of each TBA contract regardless of long or short notional position. As of March 31, 2012 and December 31, 2011, these contracts held a fair market value of \$1.5 million and \$2.7 million, included in derivative assets, at fair value, and \$3.1 million and \$5.7 million, included in derivative liabilities, at fair value, in the condensed consolidated balance sheets as of March 31, 2012 and December 31, 2011, respectively.

Mortgage Loans Held-for-Sale - The Company is exposed to interest rate risk on mortgage loans from the time of purchase until the mortgage loan is sold. Changes in interest rates impact the market price for the mortgage loans. For example, as market interest rates decline, the value of mortgage loans held-for-sale increases, and vice versa. To mitigate the impact of this risk, the Company entered into a Forward AAA Securities Agreement, or the Forward Agreement, with Barclays Bank PLC, or Barclays, under which Barclays would purchase certain securities issued in connection with a potential securitization transaction involving mortgage loans subject to the Forward Agreement. As of March 31, 2012 and December 31, 2011, one trade has been executed under the Forward Agreement with a notional of \$5.2 million for both period ends and a fair value of \$26,701 as of March 31, 2012. No fair value was assigned to the derivative at December 31, 2011 as it was entered into at market terms at the end of the year.

Repurchase Agreements - The Company monitors its repurchase agreements, which are generally floating rate debt, in relationship to the rate profile of its investment securities. When it is cost effective to do so, the Company may enter into interest rate swap arrangements to align the interest rate composition of its investment securities and debt portfolios, specifically repurchase agreements with maturities of less than 6 months. Typically, the interest receivable terms (i.e., LIBOR) of the interest rate swaps match the terms of the underlying debt, resulting in an effective conversion of the rate of the related repurchase agreement from floating to fixed.

As of March 31, 2012 and December 31, 2011, the Company had the following outstanding interest rate swaps that were utilized as economic hedges of interest rate risk associated with the Company's short-term repurchase agreements:

(notional in thousands)

March 31, 2012

| Swaps Maturities | Notional Amounts | Average Fixed Pay Rate | Average Receive Rate | Average Maturity (Years) |
|---------------------|------------------|------------------------|----------------------|--------------------------|
| 2012 | 25,000 | 0.868 | % 0.563 | % 0.73 |
| 2013 | 2,275,000 | 0.713 | % 0.513 | % 1.31 |
| 2014 | 1,675,000 | 0.644 | % 0.553 | % 2.32 |
| 2015 | 1,670,000 | 1.136 | % 0.504 | % 3.09 |
| 2016 and Thereafter | 390,000 | 1.342 | % 0.498 | % 4.46 |

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| | | | | |
|-------|-----------|-------|---------|--------|
| Total | 6,035,000 | 0.852 | % 0.521 | % 2.28 |
|-------|-----------|-------|---------|--------|

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(notional in thousands)

December 31, 2011

| Swaps Maturities | Notional Amount | Average Fixed Pay Rate | Average Receive Rate | Average Maturity (Years) |
|------------------|-----------------|------------------------|----------------------|--------------------------|
| 2012 | 25,000 | 0.868 | % 0.315 | % 0.98 |
| 2013 | 2,025,000 | 0.737 | % 0.368 | % 1.55 |
| 2014 | 1,275,000 | 0.670 | % 0.380 | % 2.72 |
| 2015 | 820,000 | 1.575 | % 0.329 | % 3.52 |
| 2016 | 240,000 | 2.156 | % 0.316 | % 4.32 |
| Total | 4,385,000 | 0.952 | % 0.361 | % 2.41 |

The Company has also entered into interest rate swaps in combination with U.S. Treasuries to economically hedge funding cost risk. As of March 31, 2012 and December 31, 2011, the Company held \$1.0 billion in fair value of U.S. Treasuries classified as trading securities and the following outstanding interest rate swaps:

(notional in thousands)

March 31, 2012

| Swaps Maturities | Notional Amounts | Average Fixed Pay Rate | Average Receive Rate | Average Maturity (Years) |
|------------------|------------------|------------------------|----------------------|--------------------------|
| 2013 | 1,000,000 | 0.644 | % 0.515 | % 1.26 |
| Total | 1,000,000 | | | |

(notional in thousands)

December 31, 2011

| Swaps Maturities | Notional Amounts | Average Fixed Pay Rate | Average Receive Rate | Average Maturity (Years) |
|------------------|------------------|------------------------|----------------------|--------------------------|
| 2013 | 1,250,000 | 0.620 | % 0.339 | % 1.54 |
| Total | 1,250,000 | | | |

As of March 31, 2012, all of the Company's interest rate swap contracts receive interest at a 1-month or 3-month LIBOR rate. As of December 31, 2011, all of the Company's interest rate swap contracts received interest at a 1-month or 3-month LIBOR rate, except the following interest rate swap entered in combination with TBA contracts to economically hedge mortgage basis widening where the Company paid interest at a 3-month LIBOR rate:

(notional in thousands)

December 31, 2011

| Swaps Maturities | Notional Amounts | Average Pay Rate | Average Fixed Receive Rate | Average Maturity (Years) |
|------------------|------------------|------------------|----------------------------|--------------------------|
| 2016 | 175,000 | 0.420 | % 1.772 | % 4.58 |
| Total | 175,000 | | | |

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Additionally, as of March 31, 2012 and December 31, 2011, the Company had the following outstanding interest rate swaptions (agreements to enter into interest rate swaps in the future for which the Company would pay a fixed rate) that were utilized as macro-economic hedges:

March 31, 2012

| (notional and dollars in thousands) | | Option | | | Underlying Swap | | | |
|---|------------|----------|------------|------------------------------------|--------------------|------------------------------|----------------------------|----------------------------|
| Swaption | Expiration | Cost | Fair Value | Average Months to Expiration | Notional Amount | Average Fixed Pay Rate | Average Receive Rate | Average Term (Years) |
| Payer | < 6 Months | \$13,653 | \$452 | 5.84 | 1,800,000 | 3.06 | % 3M Libor | 4.0 |
| Payer | ≥ 6 Months | 30,965 | 29,762 | 16.40 | 2,500,000 | 3.73 | % 3M Libor | 9.3 |
| Total Payer | | \$44,618 | \$30,214 | 15.89 | 4,300,000 | 3.45 | % 3M Libor | 7.1 |

December 31, 2011

| (notional and dollars in thousands) | | Option | | | Underlying Swap | | | |
|---|------------|----------|------------|------------------------------------|--------------------|------------------------------|----------------------------|----------------------------|
| Swaption | Expiration | Cost | Fair Value | Average Months to Expiration | Notional Amount | Average Fixed Pay Rate | Average Receive Rate | Average Term (Years) |
| Payer | < 6 Months | \$16,147 | \$4 | 4.97 | 1,600,000 | 3.22 | % 3M Libor | 3.7 |
| Payer | ≥ 6 Months | 13,523 | 5,631 | 12.27 | 1,300,000 | 3.19 | % 3M Libor | 6.5 |
| Total Payer | | \$29,670 | \$5,635 | 12.26 | 2,900,000 | 3.21 | % 3M Libor | 4.9 |

The Company has not applied hedge accounting to its current derivative portfolio held to mitigate the interest rate risk associated with its debt portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.

Foreign Currency Risk

In compliance with the Company's REIT requirements, the Company does not have exposure to foreign denominated assets or liabilities. As such, the Company is not subject to foreign currency risk.

Credit Risk

The Company's exposure to credit losses on its U.S. Treasuries and Agency portfolio of investment securities is limited because these securities are issued by the U.S. Department of the Treasury or government sponsored entities, or GSEs. The payment of principal and interest on the Freddie Mac and Fannie Mae mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on the Ginnie Mae mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

For non-Agency investment securities, the Company enters into credit default swaps to hedge credit risk. In future periods, the Company could enhance its credit risk protection, enter into further paired derivative positions, including both long and short credit default swaps and/or seek opportunistic trades in the event of a market disruption (see "Non-Risk Management Activities" section). The Company also has processes and controls in place to monitor, analyze, manage and mitigate its credit risk with respect to non-Agency RMBS.

As of March 31, 2012, the Company held credit default swaps where the Company receives credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

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The following tables present credit default swaps where the Company is receiving protection held as of March 31, 2012 and December 31, 2011:

(notional and dollars in thousands)

March 31, 2012

| Protection | Maturity Date | Average Implied Credit Spread | Current Notional Amount | Fair Value | Upfront (Payable)/Receivable | Unrealized Gain/(Loss) |
|------------|---------------|-------------------------------------|-------------------------------|------------|---------------------------------|---------------------------|
| Receive | 9/20/2013 | 460.00 | (45,000 |) \$277 | \$ (3,127 |) \$(2,850 |
| | 12/20/2013 | 181.91 | (105,000 |) 1,312 | (3,225 |) (1,913 |
| | 6/20/2016 | 105.00 | (150,000 |) (2,480 |) (355 |) (2,835 |
| | 12/20/2016 | 683.22 | (122,000 |) 3,556 | (13,062 |) (9,506 |
| | 5/25/2046 | 377.23 | (119,426 |) 60,259 | (57,322 |) 2,937 |
| | Total | 339.76 | (541,426 |) \$62,924 | \$ (77,091 |) \$(14,167 |

(notional and dollars in thousands)

December 31, 2011

| Protection | Maturity Date | Average Implied Credit Spread | Current Notional Amount | Fair Value | Upfront (Payable)/Receivable | Unrealized Gain/(Loss) |
|------------|---------------|-------------------------------------|-------------------------------|------------|---------------------------------|---------------------------|
| Receive | 9/20/2013 | 460.00 | (45,000 |) \$2,422 | \$ (3,127 |) \$(705 |
| | 12/20/2013 | 172.50 | (105,000 |) 3,742 | (3,225 |) 517 |
| | 6/20/2016 | 105.00 | (150,000 |) 2,074 | (355 |) 1,719 |
| | 12/20/2016 | 684.38 | (125,000 |) 10,200 | (13,062 |) (2,862 |
| | 5/25/2046 | 377.23 | (119,699 |) 67,698 | (57,322 |) 10,376 |
| | Total | 341.94 | (544,699 |) \$86,136 | \$ (77,091 |) \$9,045 |

Derivative financial instruments contain an element of credit risk if counterparties are unable to meet the terms of the agreements. Credit risk associated with derivative financial instruments is measured as the net replacement cost should the counterparties that owe the Company under contracts completely fail to perform under the terms of these contracts, assuming there are no recoveries of underlying collateral, as measured by the market value of the derivative financial instruments. As of March 31, 2012, the fair value of derivative financial instruments as an asset and liability position was \$340.7 million and \$47.5 million, respectively.

The Company mitigates the credit risk exposure on derivative financial instruments by limiting the counterparties to those major banks and financial institutions that meet established credit guidelines, and the Company seeks to transact with several different counterparties in order to reduce the exposure to any single counterparty. Additionally, the Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties. The agreements require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. As of March 31, 2012, the Company has received cash deposits from counterparties of \$55.6 million and placed cash deposits of \$101.8 million in accounts maintained by counterparties, of which the amounts are netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the condensed consolidated balance sheet.

In accordance with ASC 815, as amended and interpreted, the Company records derivative financial instruments on its condensed consolidated balance sheet as assets or liabilities at fair value. Changes in fair value are accounted for depending on the use of the derivative instruments and whether they qualify for hedge accounting treatment. Due to the volatility of the credit markets and difficulty in effectively matching pricing or cash flows, the Company has

elected to treat all current derivative contracts as trading instruments.

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Non-Risk Management Activities

The Company has entered into certain financial instruments that are considered derivative contracts under ASC 815 that are not for purposes of hedging. These contracts are currently limited to inverse interest-only RMBS and credit default swaps.

Inverse interest-only securities with a carrying value of \$246.1 million, including accrued interest receivable of \$3.1 million, are accounted for as derivative financial instruments in the condensed consolidated financial statements. The following table presents the amortized cost and carrying value (which approximates fair value) of inverse interest-only securities as of March 31, 2012 and December 31, 2011:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|---------------------------|-------------------|----------------------|
| Face Value | \$1,666,707 | \$1,131,084 |
| Unamortized premium | — | — |
| Unamortized discount | — | — |
| Designated credit reserve | — | — |
| Net, unamortized | (1,424,110 |) (973,066 |
| Amortized Cost | 242,597 | 158,018 |
| Gross unrealized gains | 9,475 | 4,606 |
| Gross unrealized losses | (9,127 |) (7,385 |
| Carrying Value | \$242,945 | \$155,239 |

As of March 31, 2012 and December 31, 2011, the Company also held credit default swaps where the Company provides credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

The following tables present credit default swaps where the Company is providing protection held as of March 31, 2012 and December 31, 2011:

(notional and dollars in thousands)

March 31, 2012

| Protection | Maturity Date | Average Implied Credit Spread | Current Notional Amount | Fair Value | Upfront (Payable)/Receivable | Unrealized Gain/(Loss) |
|------------|---------------|-------------------------------|-------------------------|------------|------------------------------|------------------------|
| Provide | 7/25/2036 | 352.46 | 58,795 | \$3,682 | \$ (7,403 |) \$(3,721 |
| | 5/25/2046 | 146.18 | 52,655 | (13,484 |) 13,574 | 90 |
| | | 255.01 | 111,450 | \$(9,802 |) \$ 6,171 | \$(3,631 |

(notional and dollars in thousands)

December 31, 2011

| Protection | Maturity Date | Average Implied Credit Spread | Current Notional Amount | Fair Value | Upfront (Payable)/Receivable | Unrealized Gain/(Loss) |
|------------|---------------|-------------------------------|-------------------------|------------|------------------------------|------------------------|
| Provide | 7/25/2036 | 358.71 | 99,890 | \$2,733 | \$ (11,089 |) \$(8,356 |
| | 5/25/2046 | 146.18 | 54,922 | (17,371 |) 13,574 | (3,797 |
| | | 289.59 | 154,812 | \$(14,638 |) \$ 2,485 | \$(12,153 |

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Note 10. Other Assets

Other assets as of March 31, 2012 and December 31, 2011 are summarized in the following table:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|---|-------------------|----------------------|
| Property and equipment at cost | \$465 | \$322 |
| Accumulated depreciation ⁽¹⁾ | (72) | (39) |
| Net property and equipment | 393 | 283 |
| Prepaid expenses | 574 | 722 |
| Current tax receivable | 8,109 | 157 |
| Deferred tax assets | 5,753 | 6,391 |
| Escrow deposits | 8,496 | — |
| Lease deposit | 13 | 13 |
| Total other assets | \$23,338 | \$7,566 |

(1) Depreciation expense for the three months ended March 31, 2012 was \$33,182.

Note 11. Fair Value

Fair Value Measurements

ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices available in active markets (i.e., observable inputs) and the lowest priority to data lacking transparency (i.e., unobservable inputs). Additionally, ASC 820 requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability.

ASC 820 establishes a three level hierarchy to be used when measuring and disclosing fair value. An instrument's categorization within the fair value hierarchy is based on the lowest level of significant input to its valuation.

Following is a description of the three levels:

- Level 1 Inputs are quoted prices in active markets for identical assets or liabilities as of the measurement date under current market conditions. Additionally, the entity must have the ability to access the active market and the quoted prices cannot be adjusted by the entity.
- Level 2 Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs that are observable or can be corroborated by observable market data by correlation or other means for substantially the full-term of the assets or liabilities. Unobservable inputs are supported by little or no market activity. The unobservable inputs represent the
- Level 3 assumptions that market participants would use to price the assets and liabilities, including risk. Generally, Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation.

Following are descriptions of the valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized.

Investment securities - The Company holds a portfolio of AFS and trading securities that are carried at fair value in the condensed consolidated balance sheet. AFS securities are primarily comprised of Agency and non-Agency RMBS while the Company's U.S. Treasuries are classified as trading securities. The Company determines the fair value of its U.S. Treasuries and Agency RMBS based upon prices obtained from third-party pricing providers or broker quotes

received using bid price, which are deemed indicative of market activity. In determining the fair value of its non-Agency RMBS, management judgment is used to arrive at fair value that considers prices obtained from third-party pricing providers,

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broker quotes received and other applicable market data. If observable market prices are not available or insufficient to determine fair value due to principally illiquidity in the marketplace, then fair value is based upon internally developed models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels, and credit losses). The Company classified 100.0% of its U.S. Treasuries as Level 1 fair value assets at March 31, 2012. The Company classified 100.0% of its RMBS AFS securities reported at fair value as Level 2 at March 31, 2012. AFS and trading securities account for 87.2% and 9.5% of all assets reported at fair value at March 31, 2012, respectively.

Mortgage loans held-for-sale - The Company holds a portfolio of mortgage loans held-for-sale that are carried at fair value in the condensed consolidated balance sheet as a result of a fair value option election. The Company determines fair value of its mortgage loans based on prices obtained from third-party pricing providers and other applicable market data. If observable market prices are not available or insufficient to determine fair value due principally to illiquidity in the marketplace, then fair value is based upon cash flow models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels and credit losses). The Company classified 100.0% of its mortgage loans held-for-sale as Level 3 fair value assets at March 31, 2012.

Derivative instruments - The Company may enter into a variety of derivative financial instruments as part of its hedging strategies. The Company principally executes over-the-counter, or OTC, derivative contracts, such as interest rate swaps. The Company utilizes internally developed models that are widely accepted in the market to value their OTC derivative contracts. The specific terms of the contract are entered into the model as well as market observable inputs such as interest rate forward curves and interpolated volatility assumptions. As all significant inputs into these models are market observable, the Company classified 100% of the interest rate swaps, swaptions and credit default swaps reported at fair value as Level 2 at March 31, 2012.

The Company also enters into certain other derivative financial instruments, such as TBAs and inverse interest-only securities. These instruments are similar in form to the Company's AFS securities and the Company utilizes broker quotes to value these instruments. The Company classified 100% of its inverse interest-only securities at fair value as Level 2 at March 31, 2012. The Company reported 100% of its TBAs as Level 1 as of March 31, 2012.

The Company's risk management committee governs trading activity relating to derivative instruments. The Company's policy is to minimize credit exposure related to financial derivatives used for hedging by limiting the hedge counterparties to major banks, financial institutions, exchanges, and private investors who meet established capital and credit guidelines as well as by limiting the amount of exposure to any individual counterparty. The Company has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association, or ISDA. Additionally, both the Company and the counterparty are required to post cash collateral based upon the net underlying market value of the Company's open positions with the counterparty. Posting of cash collateral typically occurs daily, subject to certain dollar thresholds. Due to the existence of netting arrangements, as well as frequent cash collateral posting at low posting thresholds, credit exposure to the Company and/or to the counterparty is considered materially mitigated. Based on the Company's assessment, there is no requirement for any additional adjustment to derivative valuations specifically for credit.

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The following tables display the Company's assets and liabilities measured at fair value on a recurring basis. The Company often economically hedges the fair value change of its assets or liabilities with derivatives and other financial instruments. The tables below display the hedges separately from the hedged items, and therefore do not directly display the impact of the Company's risk management activities.

| Recurring Fair Value Measurements At March 31, 2012 | | | | |
|---|-------------|-------------|----------|--------------|
| (in thousands) | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Available-for-sale securities | \$— | \$9,171,511 | \$— | \$9,171,511 |
| Trading securities | 1,002,090 | — | — | 1,002,090 |
| Mortgage loans held-for-sale | — | — | 5,711 | 5,711 |
| Derivative assets | 1,484 | 339,231 | — | 340,715 |
| Total assets | \$1,003,574 | \$9,510,742 | \$5,711 | \$10,520,027 |
| Liabilities | | | | |
| Derivative liabilities | \$3,133 | \$44,342 | \$— | \$47,475 |
| Total liabilities | \$3,133 | \$44,342 | \$— | \$47,475 |
| Recurring Fair Value Measurements At December 31, 2011 | | | | |
| (in thousands) | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Available-for-sale securities | \$— | \$6,238,136 | \$11,116 | \$6,249,252 |
| Trading securities | 1,003,301 | — | — | 1,003,301 |
| Mortgage loans held-for-sale | — | — | 5,782 | 5,782 |
| Derivative assets | 2,664 | 249,192 | — | 251,856 |
| Total assets | \$1,005,965 | \$6,487,328 | \$16,898 | \$7,510,191 |
| Liabilities | | | | |
| Derivative liabilities | \$5,652 | \$43,428 | \$— | \$49,080 |
| Total liabilities | \$5,652 | \$43,428 | \$— | \$49,080 |

The Company may be required to measure certain assets or liabilities at fair value from time to time. These periodic fair value measures typically result from application of certain impairment measures under GAAP. These items would constitute nonrecurring fair value measures under ASC 820. As of March 31, 2012, the Company did not have any assets or liabilities measured at fair value on a nonrecurring basis in the periods presented.

The valuation of Level 3 instruments requires significant judgment by the third-party pricing providers and/or management. The third party pricing providers and/or management rely on inputs such as market price quotations from market makers (either market or indicative levels), original transaction price, recent transactions in the same or similar instruments, and changes in financial ratios or cash flows to determine fair value. Level 3 instruments may also be discounted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the third party pricing provider in the absence of market information. Assumptions used by the third party pricing provider due to lack of observable inputs may significantly impact the resulting fair value and therefore the Company's financial statements. The Company's valuation committee reviews all valuations that are based on pricing information received from a third-party pricing provider. As part of this review, prices are compared against other pricing or input data points in the marketplace, along with internal valuation expertise, to ensure the pricing is reasonable. In addition, the Company performs back-testing of pricing information to validate price information and identify any pricing trends of a third party price provider.

In determining fair value, third party pricing providers use various valuation approaches, including market and income approaches. Inputs that are used in determining fair value of an instrument may include pricing information, credit data, volatility statistics, and other factors. In addition, inputs can be either observable or unobservable.

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The availability of observable inputs can vary by instrument and is affected by a wide variety of factors, including the type of instrument, whether the instrument is new and not yet established in the marketplace and other characteristics particular to the instrument. The third party pricing provider uses prices and inputs that are current as of the measurement date, including during periods of market dislocations. In periods of market dislocation, the availability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified to or from various levels within the fair value hierarchy.

Securities for which market quotations are readily available are valued at the bid price (in the case of long positions) or the ask price (in the case of short positions) at the close of trading on the date as of which value is determined.

Exchange-traded securities for which no bid or ask price is available are valued at the last traded price.

OTC derivative contracts, including interest rate swaps, are valued by the Company using observable inputs, such as quotations received from the counterparty, dealers or brokers, whenever available and considered reliable. In instances where models are used, the value of an OTC derivative depends upon the contractual terms of, and specific risks inherent in, the instrument as well as the availability and reliability of observable inputs. Such inputs include market prices for reference securities, yield curves, credit curves, volatility measures, prepayment rates and correlation of such inputs. Certain OTC derivatives, such as swaps, have inputs which can generally be corroborated by market data and are therefore classified within Level 2.

The table below presents the reconciliation for all of the Company's Level 3 assets and liabilities measured at fair value on a recurring basis. The Level 3 items presented below may be hedged by derivatives and other financial instruments that are classified as Level 1 or Level 2. Thus, the table below does not fully reflect the impact of the Company's risk management activities.

| | Level 3 Recurring Fair Value Measurements | |
|---|---|------------------------------|
| | Three Months Ended March 31, 2012 | |
| | Assets | |
| (in thousands) | Available-For-Sale Securities | Mortgage Loans Held-For-Sale |
| Beginning of period level 3 fair value | \$11,116 | \$5,782 |
| Gains/(losses) Included in net income: | | |
| Realized gains (losses) | — | — |
| Unrealized gains (losses) | — | (45) ⁽²⁾ |
| Total net gains/(losses) Included in net income | — | (45) |
| Other comprehensive income ⁽¹⁾ | — | — |
| Purchases | — | — |
| Sales | — | — |
| Settlements | — | (26) |
| Gross transfers Into level 3 | — | — |
| Gross transfers out of level 3 | (11,116) | — |
| End of period level 3 fair value | \$— | \$5,711 |
| Change in unrealized gains or losses for the period included in earnings for assets held at the end of the reporting period | \$— | \$(45) ⁽³⁾ |

(1) Change in unrealized gains (losses) on AFS securities is recorded in equity as accumulated other comprehensive (loss) income.

(2) For the three months ended March 31, 2012, the change in unrealized losses on mortgage loans held-for-sale were recorded in other loss on the condensed consolidated statements of comprehensive income.

(3)

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For the three months ended March 31, 2012 , the change in unrealized losses on mortgage loans held-for-sale that were held at the end of the reporting period were recorded in other loss on the condensed consolidated statements of comprehensive income.

The Company transferred three Level 3 assets in the amount of \$11.1 million into Level 2 during the three months ended March 31, 2012. The assets were deemed to be Level 2 based on the availability of third-party pricing. The Company did not incur transfers between Level 1 and Level 2 for the three months ended March 31, 2012. Transfers between Levels are deemed to take place on the first day of the reporting period in which the transfer has taken place.

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The table below presents information about the significant unobservable inputs used in the fair value measurement for the Company's Level 3 assets measured at fair value.

| Quantitative Information about Level 3 Fair Value Measurement | | | | | |
|---|------------|----------------------|-----------------------------------|-------------|---|
| As of March 31, 2012 | | | | | |
| (in thousands) | Fair Value | Valuation Technique | Unobservable Input ⁽¹⁾ | Input Value | |
| | | | Constant prepayment speed | 17.80 | % |
| Mortgage loans held-for-sale | \$5,711 | Discounted cash flow | Expected default | 3.00 | % |
| | | | Severity | 25.00 | % |
| | | | Discount rate | 4.22 | % |

Significant increases (decreases) in any of the inputs in isolation may result in significantly lower (higher) fair value measurement. A change in the assumption used for the probability of default may be accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

Fair Value Option for Financial Assets and Financial Liabilities

The Company elected the fair value option for the residential mortgage loans it acquires. The fair value option was elected to mitigate earnings volatility by better matching the accounting for the assets with the related hedges. The residential mortgage loans are carried within mortgage loans held-for-sale on the condensed consolidated balance sheet. The Company's policy is to separately record interest income on these fair value elected loans. Upfront fees and costs related to the fair value elected loans are not deferred or capitalized. Fair value adjustments are reported in other loss on the condensed consolidated statements of comprehensive income. The fair value option is irrevocable once the loan is acquired.

The following table summarizes the fair value option elections and information regarding the amounts recognized in earnings for each fair value option-elected item.

| Changes included in the Condensed Consolidated Statements of Comprehensive Income | | | | |
|---|--------------------------------|---------------------------------------|------------------------------|---|
| Three Months Ended March 31, 2012 | | | | |
| (in thousands) | Interest Income ⁽¹⁾ | Loss on Mortgage Loans ⁽²⁾ | Total Included in Net Income | Change in Fair Value Due to Credit Risk |
| Assets | | | | |
| Mortgage loans held-for-sale | \$69 | \$(45) |) \$24 | \$— |
| Total assets | \$69 | \$(45) |) \$24 | \$— |

(1) Interest income on mortgage loans held-for-sale is measured by multiplying the unpaid principal balance on the loans by the coupon rate and the number of days of interest due.

(2) Loss on mortgage loans is recorded in other loss on the condensed consolidated statements of comprehensive income.

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The table below provides the fair value and the unpaid principal balance for the Company's fair value option-elected loans.

| (in thousands) | March 31, 2012 | | December 31, 2011 | |
|------------------------------|--------------------------------|---------------------------|--------------------------------|---------------------------|
| | Unpaid Principal Balance | Fair Value ⁽¹⁾ | Unpaid Principal Balance | Fair Value ⁽¹⁾ |
| Mortgage loans held-for-sale | | | | |
| Total loans | \$5,629 | \$5,711 | \$5,655 | \$5,782 |
| Nonaccrual loans | \$— | \$— | \$— | \$— |
| Loans 90+ days past due | \$— | \$— | \$— | \$— |

(1) Excludes accrued interest receivable.

Fair Value of Financial Instruments

In accordance with ASC 820, the Company is required to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the condensed consolidated balance sheet, for which fair value can be estimated.

The following describes the Company's methods for estimating the fair value for financial instruments. Descriptions are not provided for those items that have zero balances as of the current balance sheet date.

AFS securities, trading securities, mortgage loans held-for-sale, derivative assets and liabilities are recurring fair value measurements; carrying value equals fair value. See discussion of valuation methods and assumptions within the Fair Value Measurements section of this footnote.

Cash and cash equivalents and restricted cash have a carrying value which approximates fair value because of the short maturities of these instruments. The Company categorizes the fair value measurement of these assets as Level 1. The carrying value of repurchase agreements that mature in less than one year generally approximates fair value due to the short maturities. The Company holds \$80.0 million of repurchase agreements that are considered long-term. The Company's long-term repurchase agreements have floating rates based on an index plus a spread. These borrowings have been recently entered into and the credit spread is typically consistent with those demanded in the market. Accordingly, the interest rates on these borrowings are at market and thus carrying value approximates fair value. The Company categorizes the fair value measurement of these liabilities as Level 1.

Note 12. Repurchase Agreements

The Company had outstanding \$8.7 billion of repurchase agreements, including repurchase agreements funding the Company's U.S. Treasuries of \$1.0 billion. Excluding the debt associated with the Company's U.S. Treasuries and the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 0.69% and weighted average remaining maturities of 80 days as of March 31, 2012. The Company had outstanding \$6.7 billion of repurchase agreements with a weighted average borrowing rate of 0.78%, excluding the debt associated with the Company's U.S. Treasuries and the effect of the Company's interest rate swaps, and weighted average remaining maturities of 73 days as of December 31, 2011. As of March 31, 2012 and December 31, 2011, the debt associated with the Company's U.S. Treasuries had a weighted borrowing rate of 0.20% and 0.12%, respectively. At March 31, 2012 and December 31, 2011, the repurchase agreement balances were as follows:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|----------------|-------------------|----------------------|
| | | |
| Short-term | \$8,613,756 | \$6,610,148 |
| Long-term | 80,000 | 50,000 |
| Total | \$8,693,756 | \$6,660,148 |

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At March 31, 2012 and December 31, 2011, the repurchase agreements had the following characteristics:

| (dollars in thousands) | March 31, 2012 | | | December 31, 2011 | | |
|------------------------------|-----------------------|---------------------------------------|---|-----------------------|---------------------------------------|---|
| Collateral Type | Amount Outstanding | Weighted Average Borrowing Rate | | Amount Outstanding | Weighted Average Borrowing Rate | |
| U.S. Treasuries | \$1,001,250 | 0.20 | % | \$1,001,250 | 0.12 | % |
| Agency RMBS | 6,499,814 | 0.43 | % | 4,804,533 | 0.50 | % |
| Non-Agency RMBS | 1,009,353 | 2.29 | % | 731,014 | 2.61 | % |
| Agency derivatives | 178,048 | 1.14 | % | 118,032 | 0.97 | % |
| Mortgage loans held-for-sale | 5,291 | 3.14 | % | 5,319 | 3.20 | % |
| Total | \$8,693,756 | 0.63 | % | \$6,660,148 | 0.68 | % |

As of March 31, 2012, the amounts outstanding under repurchase agreements includes \$96.3 million of borrowings under the 364-day repurchase facility with Wells Fargo Bank National Association, or Wells Fargo. As of March 31, 2012, the facility provided an aggregate maximum borrowing capacity of \$150.0 million and is set to mature on July 25, 2012. The facility is collateralized by non-Agency RMBS and its weighted average borrowing rate as of March 31, 2012 was 1.98%. As of December 31, 2011, the amounts outstanding under repurchase agreements included \$130.0 million of borrowings under the 364-day repurchase facility with Wells Fargo. As of December 31, 2011, the facility provided an aggregate maximum borrowing capacity of \$150.0 million. The facility was collateralized by non-Agency RMBS and its weighted average borrowing rate as of December 31, 2011 was 2.07%. The facility requires the Company to maintain certain financial covenants under the guaranty agreement with Wells Fargo. As of March 31, 2012 and December 31, 2011, the Company was in compliance with these covenants. As of March 31, 2012, the Company's amounts outstanding under repurchase agreements included \$5.3 million of borrowings under the 364-day repurchase facility with Barclays. The facility provides an aggregate maximum borrowing capacity of \$100.0 million and is set to mature on May 16, 2012, unless extended pursuant to its terms. The facility is collateralized by eligible residential mortgage loans and its weighted average borrowing rate as of March 31, 2012 was 3.14%. As of December 31, 2011, the Company's amounts outstanding under repurchase agreements included \$5.3 million of borrowings under the 364-day repurchase facility with Barclays. As of December 31, 2011, the facility provided an aggregate maximum borrowing capacity of \$100.0 million. The facility was collateralized by eligible residential mortgage loans and its weighted average borrowing rate as of December 31, 2011 was 3.20%. The facility requires the Company to maintain certain financial covenants under the guaranty agreement with Barclays. As of March 31, 2012 and December 31, 2011, the Company was in compliance with these covenants.

At March 31, 2012 and December 31, 2011, the repurchase agreements had the following remaining maturities:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|----------------------------------|----------------|-------------------|
| Within 30 days | \$2,081,095 | \$1,967,009 |
| 30 to 59 days ⁽¹⁾ | 1,662,224 | 1,263,060 |
| 60 to 89 days | 831,225 | 1,096,410 |
| 90 to 119 days | 1,567,329 | 359,171 |
| 120 to 364 days ⁽²⁾ | 1,470,633 | 923,248 |
| Open maturity ⁽³⁾ | 1,001,250 | 1,001,250 |
| One year and over ⁽⁴⁾ | 80,000 | 50,000 |
| Total | \$8,693,756 | \$6,660,148 |

(1) 30 to 59 days includes the amounts outstanding under the Barclays 364-day borrowing facility.

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- (2) 120 to 364 days includes the amounts outstanding under the Wells Fargo 364-day borrowing facility.
- (3) Repurchase agreements collateralized by U.S. Treasuries include an open maturity period (i.e., rolling 1-day maturity) renewable at the discretion of either party to the agreements.
- (4) One year and over includes repurchase agreements with a maturity date of December 23, 2013.

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The following table summarizes assets at carrying value that are pledged or restricted as collateral for the future payment obligations of repurchase agreements:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Available-for-sale securities, at fair value | \$8,606,739 | \$6,160,229 |
| Trading securities, at fair value | 1,002,090 | 1,003,301 |
| Mortgage loans held-for-sale | 5,711 | 5,782 |
| Cash and cash equivalents | 10,000 | 15,000 |
| Restricted cash | 46,180 | 94,803 |
| Due from counterparties | 57,341 | 32,201 |
| Derivative assets, at fair value | 227,304 | 145,779 |
| Total | \$9,955,365 | \$7,457,095 |

Although the repurchase agreements are committed borrowings until maturity, 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.

The following table summarizes certain characteristics of the Company's repurchase agreements and counterparty concentration at March 31, 2012 and December 31, 2011:

| | March 31, 2012 | | | | | December 31, 2011 | | | | |
|---|--------------------|--|-------------------|-----------------------------------|--|--------------------|--|-------------------|-----------------------------------|--|
| (dollars in thousands) | Amount Outstanding | Net Counterparty Exposure ⁽¹⁾ | Percent of Equity | Weighted Average Days to Maturity | | Amount Outstanding | Net Counterparty Exposure ⁽¹⁾ | Percent of Equity | Weighted Average Days to Maturity | |
| JP Morgan Chase ⁽²⁾ | \$1,608,354 | \$265,317 | 13 % | 113.6 | | \$1,250,629 | \$184,046 | 14 % | 70.0 | |
| Credit Suisse | 280,498 | 237,801 | 11 % | 20.0 | | 95,691 | 46,006 | 4 % | 14.1 | |
| All other counterparties ⁽³⁾ | 5,803,654 | 768,859 | 37 % | 74.0 | | 4,312,578 | 567,440 | 45 % | 75.1 | |
| Total | \$7,692,506 | \$1,271,977 | | | | \$5,658,898 | \$797,492 | | | |

Represents the net carrying value of the securities sold under agreements to repurchase, including accrued interest plus any cash or assets on deposit to secure the repurchase obligation, less the amount of the repurchase liability,

(1) including accrued interest. At March 31, 2012 and December 31, 2011, the Company had \$413.1 million and \$45.6 million, respectively, in payables due to broker counterparties for unsettled securities purchases. The payables are not included in the amounts presented above.

(2) Excludes repurchase agreements collateralized by U.S. Treasuries with a rolling 1-day maturity.

(3) Represents amounts outstanding to 18 and 17 counterparties at March 31, 2012 and December 31, 2011, respectively.

The Company does not anticipate any defaults by its repurchase agreement counterparties.

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Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 13. Stockholders' Equity

Distributions to stockholders

The following table presents cash dividends declared by the Company on its common stock from October 28, 2009 through March 31, 2012:

| Declaration Date | Record Date | Payment Date | Cash Dividend Per Share |
|--------------------|--------------------|------------------|-------------------------|
| March 14, 2012 | March 26, 2012 | April 20, 2012 | \$0.40 |
| December 14, 2011 | December 27, 2011 | January 20, 2012 | \$0.40 |
| September 14, 2011 | September 26, 2011 | October 20, 2011 | \$0.40 |
| June 14, 2011 | June 24, 2011 | July 20, 2011 | \$0.40 |
| March 2, 2011 | March 14, 2011 | April 14, 2011 | \$0.40 |
| December 8, 2010 | December 17, 2010 | January 20, 2011 | \$0.40 |
| September 13, 2010 | September 30, 2010 | October 21, 2010 | \$0.39 |
| June 14, 2010 | June 30, 2010 | July 22, 2010 | \$0.33 |
| March 12, 2010 | March 31, 2010 | April 23, 2010 | \$0.36 |
| December 21, 2009 | December 31, 2009 | January 26, 2010 | \$0.26 |

Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) at March 31, 2012 and December 31, 2011 was as follows:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|---|-------------------|----------------------|
| Available-for-sale securities, at fair value | | |
| Unrealized gains | \$191,460 | \$120,745 |
| Unrealized losses | (106,266) | (179,461) |
| Accumulated other comprehensive income (loss) | \$85,194 | \$(58,716) |

Public offerings

On January 17, 2012, the Company completed a public offering of 34,000,000 shares of its common stock and issued an additional 5,100,000 shares of common stock pursuant to the underwriters' over-allotments at a price of \$9.17 per share, for gross proceeds of approximately \$358.5 million. On February 24, 2012, the Company completed a public offering of 30,000,000 shares of its common stock and issued an additional 4,500,000 shares of common stock pursuant to the underwriter's over-allotments at a price of \$9.90 per share, for gross proceeds of approximately \$341.6 million. Net proceeds to the Company from the two offerings were approximately \$691.9 million, net of issuance costs of approximately \$8.2 million.

Dividend Reinvestment and Direct Stock Purchase Plan

The Company sponsors a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of the Company's common stock by reinvesting some or all of the cash dividends received on shares of the Company's common stock. Stockholders may also make optional cash purchases of shares of the Company's common stock subject to certain limitation detailed in the plan prospectus. An aggregate of 7.5 million shares of our common stock have been reserved for issuance under the plan. As of March 31, 2012, 36,384 shares have been issued under the plan for total proceeds of \$0.4 million.

Share Repurchase Program

On October 5, 2011, the Company's Board of Directors authorized a Share Repurchase Program, which allows the Company to repurchase up to 10,000,000 shares of its common stock. The shares are expected to be repurchased from time to time through privately negotiated transactions or open market transactions, pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Securities Exchange Act of 1934, as amended, or by any

combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors,

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

including market conditions and applicable U.S. Securities and Exchange Commission rules. The Company did not repurchase any of its common stock during the fiscal year ended December 31, 2011 or the three months ended March 31, 2012.

Note 14. Other Operating Expenses

Components of the Company's other operating expenses for the three months ended March 31, 2012 and 2011 are presented in the following table:

| | Three Months Ended March 31, | |
|-----------------------------------|------------------------------|---------|
| | 2012 | 2011 |
| Other operating expenses: | | |
| General and administrative | \$3,068 | \$1,105 |
| Directors and officers' insurance | 115 | 141 |
| Professional fees | 401 | 266 |
| Real estate expenses | 17 | — |
| Total other operating expenses | \$3,601 | \$1,512 |

Note 15. Income Taxes

For the three months ended March 31, 2012 and 2011, the Company qualified to be taxed as a REIT under the Code for U.S. federal income tax purposes. As long as the Company qualifies as a REIT, the Company generally will not be subject to U.S. federal income taxes on its taxable income to the extent it annually distributes its net taxable income to stockholders, does not engage in prohibited transactions, and maintains its intended qualification as a REIT. The majority of states also recognize the Company's REIT status. The Company has two TRSs, Capitol Acquisition Corp., or Capitol, and TH TRS Corp., each of which file separate tax returns and are fully taxed as standalone U.S.

C-Corporations. The tables below reflect the net taxes accrued at the TRS level and the tax attributes included in the condensed consolidated financial statements. It is assumed that the Company will retain its REIT status and will incur no REIT level taxation as it intends to comply with the REIT regulations and annual distribution requirements. Certain activities the Company performs may produce income that will not be qualifying income for REIT purposes. These activities include holding swaptions, credit default swaps, TBAs and other risk-management instruments and has designated Capitol to engage in these activities. The Company purchases and intends to sell mortgage loans through the secondary whole loan market and/or securitization market and has designated TH TRS Corp. to engage in these activities.

The following table summarizes the tax (benefit) provision recorded at the taxable subsidiary level for the three months ended March 31, 2012 and 2011:

| (in thousands) | Three Months Ended March 31, | |
|---|------------------------------|---------|
| | 2012 | 2011 |
| Current tax (benefit) provision: | | |
| Federal | \$(8,375 |) \$270 |
| State | 2 | — |
| Total current tax (benefit) provision | (8,373 |) 270 |
| Deferred tax provision | 796 | 487 |
| Total (benefit from) provision for income taxes | \$(7,577 |) \$757 |

The Company's taxable income before dividend distributions differs from its GAAP pre-tax net income primarily due to unrealized gains and losses, the recognition of credit losses for GAAP but not tax, differences in timing of income recognition due to market discount, and original issue discount and the calculations surrounding each, and a distribution paid by Capitol to Two Harbors which is classified as a taxable dividend. These book to tax differences in

the REIT are not reflected in the financial statements as the Company believes it will retain its REIT status.

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Notes to the Condensed Consolidated Financial Statements (unaudited)

The following is a reconciliation of the statutory federal and state rates to the effective rates, for the three months ended March 31, 2012 and 2011:

| (dollars in thousands) | Three Months Ended March 31, | | | | | |
|---|------------------------------|---------|-----------|---------|---|--|
| | 2012 | | 2011 | | | |
| | Amount | Percent | Amount | Percent | | |
| Computed income tax expense at federal rate | \$15,036 | 34 | % \$7,866 | 34 | % | |
| State taxes, net of federal benefit, if applicable | 2 | — | % — | — | % | |
| Permanent differences in taxable income from GAAP income (loss) | 15 | — | % 1 | — | % | |
| Dividends paid deduction | (22,630) | (51)% | (7,110) | (31)% | | |
| (Benefit from) provision for income taxes/Effective Tax Rate ⁽¹⁾ | \$(7,577) | (17)% | \$757 | 3 | % | |

(1) The (benefit from) provision for income taxes is recorded at the taxable subsidiary level.

The Company's condensed consolidated balance sheet, as of March 31, 2012 and December 31, 2011, contains the following current and deferred tax assets and liabilities, recorded at the taxable subsidiary level:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|---------------------------------------|-------------------|----------------------|
| Current tax | | |
| Federal income tax payable | \$— | \$(3,898) |
| Current taxes receivable | 8,109 | 157 |
| State and local income tax payable | — | — |
| Current tax receivable (payable), net | 8,109 | (3,741) |
| Deferred tax assets (liabilities) | | |
| Deferred tax asset | 6,425 | 9,710 |
| Deferred tax liability | (672) | (3,319) |
| Deferred tax asset, net | 5,753 | 6,391 |
| Total tax assets and liabilities, net | \$13,862 | \$2,650 |

Deferred Tax Assets and Liabilities

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting and tax purposes. Components of the Company's deferred tax assets and liabilities as of March 31, 2012 and December 31, 2011 are as follows:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Unrealized loss on derivative assets | \$6,200 | \$7,429 |
| Unrealized gain on trading securities and mortgage loans held-for-sale | (624) | (1,038) |
| Capitalized start-up and organizational costs | 177 | — |
| Total net deferred tax assets | \$5,753 | \$6,391 |

At March 31, 2012 and December 31, 2011, the Company has not recorded a valuation allowance for any portion of its deferred tax assets as it does not believe, at a more likely than not level, that any portion of its deferred tax assets will not be realized. The Company estimates, based on existence of sufficient evidence, the ability to realize the remainder of its deferred tax assets. Any adjustments to such estimates will be made in the period such determination is made.

Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's financial statements of a contingent tax liability for uncertain tax positions. Additionally, there

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Notes to the Condensed Consolidated Financial Statements (unaudited)

were no amounts accrued for penalties or interest as of or during the periods presented in these condensed consolidated financial statements.

Note 16. Earnings Per Share

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted earnings per share, or EPS, for the three months ended March 31, 2012 and 2011:

| (in thousands, except share data) | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2012 | 2011 |
| Numerator: | | |
| Net income attributable to common stockholders for basic and diluted earnings per share | \$51,800 | \$22,377 |
| Denominator: | | |
| Weighted average common shares outstanding | 186,804,142 | 45,561,141 |
| Weighted average restricted stock shares | 51,447 | 51,235 |
| Basic and diluted weighted average shares outstanding | 186,855,589 | 45,612,376 |
| Basic and Diluted Earnings Per Share: | \$0.28 | \$0.49 |

For the three months ended March 31, 2012 and 2011, the Company has assumed that no warrants would be exercised as the weighted average market value per share of the Company's common stock was below the strike price of the warrants and the warrants would be anti-dilutive.

Note 17. Related Party Transactions

The following summary provides disclosure of the material transactions with affiliates of the Company.

In accordance with the Management Agreement with PRCM Advisers, the Company incurred \$6.7 million and \$1.6 million as a management fee to PRCM Advisers for the three months ended March 31, 2012 and 2011, respectively, which represents approximately 1.5% of stockholders' equity on an annualized basis as defined by the Management Agreement. In addition, the Company reimbursed PRCM Advisers for direct and allocated costs incurred by PRCM Advisers on behalf of the Company. These direct and allocated costs totaled approximately \$4.4 million and \$0.9 million for the three months ended March 31, 2012 and 2011, respectively. Approximately \$3.4 million and \$0.7 million was expensed for the three months ended March 31, 2012 and 2011, respectively. Approximately \$0.5 million and \$0.1 million were considered prepaid and classified as other assets on the condensed consolidated balance sheet for the three months ended March 31, 2012 and 2011. Approximately \$0.5 million and \$0.1 million in out-of-pocket expenses was charged against equity as a cost of raising capital for the three months ended March 31, 2012 and 2011, respectively.

The Company recognized \$60,070 and \$62,498 of compensation expense during the three months ended March 31, 2012 and 2011, respectively, associated with the amortization of shares of restricted stock issued to the independent directors.

As of March 31, 2012, there were 33,249,000 publicly-held registered warrants to purchase up to 33,249,000 shares of common stock issued and outstanding. Of the 33,249,000 warrants, 7,000,000 are beneficially owned by the founders of Capitol, and 2,906,918 are beneficially owned by Pine River Master Fund Ltd. and Nisswa Acquisition Master Fund Ltd., which are investment funds managed by Pine River. The Company is required to maintain a resale registration statement for the warrants and common stock issuable upon exercise thereof that are held by Pine River Master Fund Ltd., Nisswa Acquisition Master Fund Ltd., and the founders of Capitol.

On February 3, 2012, a subsidiary of the Company entered into an Acquisition Services Agreement, a Property Management Agreement and a side letter agreement regarding certain fees with Silver Bay Property Management

LLC, or Silver Bay, which is a joint venture between Provident Real Estate Advisors LLC and an affiliate of PRCM Advisers and Pine River. Under the Acquisition Services Agreement, Silver Bay will assist the Company's subsidiary in identifying and acquiring a portfolio of residential real properties in various geographic areas throughout the U.S. Under the Property Management Agreement, Silver Bay will operate, maintain, repair, manage and lease the residential properties and collect rental income for the benefit of the Company and its affiliates. Pursuant to the side letter, the Company's subsidiary is obligated to pay Silver Bay for various services provided under the Acquisition Services and the Property Management Agreements.

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Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 18. Subsequent Events

Events subsequent to March 31, 2012 were evaluated through the date these financial statements were issued and no additional events were identified requiring further disclosure in these Condensed Consolidated Financial Statements.

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

The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements and accompanying notes included elsewhere in this Quarterly Report on Form 10-Q as well as our Annual Report on Form 10-K for the year ended December 31, 2011.

General

We are a Maryland corporation focused on investing in, financing and managing residential mortgage-backed securities, or RMBS, residential mortgage loans, residential real properties and other financial assets. We operate as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code. We are externally managed by PRCM Advisers LLC. PRCM Advisers is a wholly-owned subsidiary of Pine River Capital Management L.P., or Pine River, a global asset management firm providing solutions to qualified clients across three actively managed platforms: hedge funds, managed accounts and listed investment vehicles. Our objective is to provide attractive risk-adjusted returns to our stockholders over the long term, primarily through dividends and secondarily through capital appreciation. We selectively acquire and manage an investment portfolio of our target assets, which we believe is constructed to generate attractive returns through market cycles. Our target assets include the following:

- Agency RMBS, meaning RMBS whose principal and interest payments are guaranteed by the Government National Mortgage Association (or Ginnie Mae), the Federal National Mortgage Association (or Fannie Mae), or the Federal Home Loan Mortgage Corporation (or Freddie Mac);
- Non-Agency RMBS, meaning RMBS that are not issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac;
- Residential mortgage loans;
- Residential real properties; and
- Other financial assets comprising approximately 5% to 10% of the portfolio.

We believe our hybrid Agency and non-Agency RMBS investment model allows management to focus on security selection and implement a relative value investment approach across various sectors within the residential mortgage market, which factors in the displaced pricing opportunities in the marketplace, cost of financing and cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, RMBS asset allocation reflects management's opportunistic approach to investing in the marketplace.

The following table provides the RMBS asset allocation between Agency and non-Agency RMBS as of March 31, 2012 and the four immediately preceding period ends:

| | As of March 31, 2012 | December 31, 2011 | September 30, 2011 | June 30, 2011 | March 31, 2011 | |
|----------------------------|----------------------------|----------------------|-----------------------|------------------|-------------------|---|
| Agency RMBS ⁽¹⁾ | 79.4 | % 81.3 | % 80.9 | % 83.7 | % 82.3 | % |
| Non-Agency RMBS | 20.6 | % 18.7 | % 19.1 | % 16.3 | % 17.7 | % |

(1) Agency RMBS includes inverse interest-only securities which are classified as derivatives for purposes of U.S. GAAP.

As our RMBS asset allocation shifts, our annualized yields and cost of financing shifts. As previously discussed, our investment decisions are not driven solely by annualized yields, but rather a multitude of macroeconomic drivers, including market environments and their respective impacts; for example, uncertainty of faster prepayments, extension risk and credit events.

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The following table provides the average annualized yield on our Agency and non-Agency RMBS for the three months ended March 31, 2012, and the four immediately preceding quarters:

| | Three Months Ended | | | | | |
|--|--------------------|----------------------|-----------------------|------------------|-------------------|---|
| | March 31, 2012 | December 31, 2011 | September 30, 2011 | June 30, 2011 | March 31, 2011 | |
| Average annualized yields ⁽¹⁾ | | | | | | |
| Agency RMBS ⁽²⁾ | 3.5 | % 3.5 | % 4.3 | % 4.7 | % 3.9 | % |
| Non-Agency RMBS | 9.7 | % 9.7 | % 9.8 | % 8.8 | % 9.7 | % |
| Aggregate RMBS | 4.9 | % 4.8 | % 5.5 | % 5.4 | % 5.2 | % |
| Cost of financing ⁽³⁾ | 1.0 | % 1.0 | % 1.3 | % 1.3 | % 1.4 | % |
| Net interest spread | 3.9 | % 3.8 | % 4.2 | % 4.1 | % 3.8 | % |

(1) Average annualized yield incorporates future prepayment, credit loss and other assumptions, all of which are estimates and subject to change.

(2) Agency RMBS includes inverse interest-only securities which are classified as derivatives under U.S. GAAP.

(3) Cost of financing includes swap interest rate spread.

The following table provides the average annualized yield on our Agency and non-Agency RMBS as of March 31, 2012, and the four immediately preceding period ends:

| | As of | | | | | |
|--|-------------------|----------------------|-----------------------|------------------|-------------------|---|
| | March 31, 2012 | December 31, 2011 | September 30, 2011 | June 30, 2011 | March 31, 2011 | |
| Average annualized yields ⁽¹⁾ | | | | | | |
| Agency RMBS ⁽²⁾ | 3.5 | % 3.3 | % 3.4 | % 3.9 | % 3.9 | % |
| Non-Agency RMBS | 9.7 | % 9.7 | % 9.6 | % 9.2 | % 9.7 | % |
| Aggregate RMBS | 4.7 | % 4.7 | % 4.7 | % 4.8 | % 5.2 | % |
| Cost of financing ⁽³⁾ | 1.0 | % 1.0 | % 1.3 | % 1.3 | % 1.4 | % |
| Net interest spread | 3.7 | % 3.7 | % 3.4 | % 3.5 | % 3.8 | % |

(1) Average annualized yield incorporates future prepayment, credit loss and other assumptions, all of which are estimates and subject to change.

(2) Agency RMBS includes inverse interest-only securities which are classified as derivatives for purposes of U.S. GAAP.

(3) Cost of financing includes swap interest rate spread.

We seek to deploy moderate leverage as part of our investment strategy. We generally finance our RMBS assets through short-term borrowings structured as repurchase agreements. Our Agency RMBS and Agency derivatives, given their liquidity and high credit quality, are eligible for higher levels of leverage, while non-Agency RMBS, with less liquidity and exposure to credit risk, utilize lower levels of leverage. We also finance our U.S. Treasuries, which we hold for trading purposes, and our mortgage loans. We believe the debt-to-equity ratio funding our RMBS, Agency derivatives and residential mortgage loans is the most meaningful leverage measure as U.S. Treasuries are viewed to be highly liquid in nature. As a result, our debt-to-equity ratio is determined by our RMBS portfolio mix as well as many additional factors, including the liquidity of our portfolio, the sustainability and price of our financing, diversification of our counterparties and their available capacity to finance our RMBS assets, and anticipated regulatory developments. Over the past several quarterly periods, we have generally maintained a debt-to-equity ratio range of 3.0 to 5.0 times to finance our RMBS, Agency derivatives and mortgage loans, on a fully deployed capital basis. The range has been driven by our relatively stable asset allocation between Agency and non-Agency RMBS, as

disclosed above. See the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Financial Condition -- Repurchase Agreements" for further discussion.

We compete with other investment vehicles for attractive investment opportunities. We rely on our management team and Pine River, who have developed strong relationships with a diverse group of financial intermediaries, to identify investment opportunities. In addition, we have benefited and expect to continue to benefit from Pine River's analytical and portfolio management expertise and infrastructure. We believe that our significant focus on the RMBS area, the extensive

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RMBS expertise of our investment team, our strong analytics and our disciplined relative value investment approach give us a competitive advantage versus our peers.

We have elected to be treated as a REIT for U.S. federal income tax purposes. To qualify as a REIT we are required to meet certain investment and operating tests and annual distribution requirements. 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 stockholders, do not participate in prohibited transactions and maintain our intended qualification as a REIT.

However, certain activities that we may perform may cause us to earn income which will not be qualifying income for REIT purposes. We have designated certain of our subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and we may form additional TRSs in the future. We also operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940, as amended, or the 1940 Act.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains, or incorporates by reference, not only historical information, but also forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, as amended. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as “anticipate,” “estimate,” “will,” “should,” “expect,” “target,” “believe,” “intend,” “plan” and similar expressions or their negative forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this Annual Report on Form 10-K under the caption “Risk Factors.” Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update or revise any such forward-looking statements, whether as a result of new information, future events, or otherwise.

Important factors, among others, that may affect our actual results include:

- changes in interest rates and the market value of our target assets;
- changes in prepayment rates of mortgages underlying our target assets;
- the timing of credit losses within our portfolio;
 - our exposure to adjustable-rate and negative amortization mortgage loans underlying our target assets;
- the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers;
- the concentration of the credit risks we are exposed to;
- legislative and regulatory actions affecting the mortgage and derivative industries or our business;
- the availability of target assets for purchase at attractive prices;
- the availability of financing for our portfolio, including the availability of repurchase agreement financing;
- declines in home prices;
 - increases in payment delinquencies and defaults on the mortgages underlying our Non-Agency securities;
- changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets,
- inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale;
- changes in the values of securities we own and the impact of adjustments reflecting those changes on our income statement and balance sheet, including our stockholders' equity;

- our ability to generate the amount of cash flow we expect from our investment portfolio;
- changes in our investment, financing, and hedging strategies and the new risks that those changes may expose us to;
- changes in the competitive landscape within our industry, including changes that may affect our ability to retain or attract personnel;
- our ability to build successful relationships with loan originators;
- our ability to acquire mortgage loans in connection with our securitization plans;
- our ability to securitize the mortgage loans that we acquire;

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- our ability to acquire residential real properties at attractive prices and lease such properties on a profitable basis or to resell such properties at a gain;
- our ability to manage various operational risks associated with our business;
- our ability to maintain appropriate internal controls over financial reporting;
- our ability to establish, adjust and maintain appropriate hedges for the risks in our portfolio;
- our ability to maintain our REIT qualification for U.S. federal income tax purposes;
- limitations imposed on our business due to our REIT status and our status as exempt from registration under the 1940 Act; and
- our future ability to offer and sell securities using a shelf registration statement on Form S-3.

This Quarterly Report on Form 10-Q may contain statistics and other data that in some cases have been obtained or compiled from information made available by mortgage loan servicers and other third-party service providers.

Factors Affecting our Operating Results

Our net interest income includes income from our RMBS portfolio and will reflect the amortization of purchase premiums and accretion of purchase discounts. Net interest income will fluctuate primarily as a result of changes in market interest rates, our financing costs, and prepayment speeds on our assets. Interest rates, financing costs and prepayment rates 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. Our operating results will also be affected by default rates and credit losses with respect to the mortgage loans underlying our non-Agency RMBS.

Fair Value Measurement

ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between willing market participants at the measurement date. It also establishes three levels of input to be used when measuring fair value:

- | | |
|---------|--|
| Level 1 | Inputs are quoted prices in active markets for identical assets or liabilities as of the measurement date under current market conditions. Additionally, the entity must have the ability to access the active market and the quoted prices cannot be adjusted by the entity. |
| Level 2 | Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs that are observable or can be corroborated by observable market data by correlation or other means for substantially the full-term of the assets or liabilities. |
| Level 3 | Unobservable inputs are supported by little or no market activity. The unobservable inputs represent the assumptions that market participants would use to price the assets and liabilities, including risk. Generally, Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation. |

We follow the fair value hierarchy set forth above in order to prioritize the data utilized to measure fair value. We strive to obtain quoted market prices in active markets (Level 1 inputs). If Level 1 inputs are not available, we will attempt to obtain Level 2 inputs, observable market prices in inactive markets or derive the fair value measurement using observable market prices for similar assets or liabilities. When neither Level 1 nor Level 2 inputs are available, we use Level 3 inputs and independent pricing service models to estimate fair value measurements. At March 31, 2012, approximately 92.8% of total assets, or \$10.5 billion, and approximately 0.5% of total liabilities, or \$47.5 million, consisted of financial instruments recorded at fair value. As of March 31, 2012, we had \$5.7 million, or less than one percent, of total assets reported at fair value using Level 3 inputs. See Note 10 - Fair Value to the Condensed Consolidated Financial Statements, included in this Annual Report on Form 10-K, for descriptions of valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized.

A significant portion of our assets and liabilities are at fair value and, therefore, our condensed consolidated balance sheet and income statement are significantly affected by fluctuations in market prices. Although we execute various hedging strategies to mitigate our exposure to changes in fair value, we cannot fully eliminate our exposure to volatility caused by fluctuations in market prices. Starting in 2007, markets for asset-backed securities, including RMBS, have experienced severe dislocations. While these market disruptions continue, our assets and liabilities will be subject to valuation adjustment as well as changes in the inputs we use to measure fair value.

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For the three months ended March 31, 2012, our unrealized fair value losses on interest rate swap and swaption agreements, which are accounted for as derivative trading instruments under GAAP, negatively affected our financial results while, for the three months ended March 31, 2011, our unrealized fair value gains on interest rate swap and swaption agreements, positively affected our financial results. The change in fair value of the interest rate swaps was a result of changes to LIBOR, the swap curve, and corresponding counterparty borrowing rates during the three months ended March 31, 2012. Our financial results for the three months ended March 31, 2012 were negatively affected by unrealized fair value losses on certain U.S. Treasuries classified as trading instruments due to their short-term investment objectives. In addition, our financial results for the three months ended March 31, 2012 were affected by the unrealized gains and losses of certain other derivative instruments that were accounted for as trading derivative instruments, i.e., credit default swaps, TBAs and inverse interest-only securities. Any temporary change in the fair value of our available-for-sale securities is recorded as a component of accumulated other comprehensive income and does not impact our earnings.

We have numerous internal controls in place to help ensure the appropriateness of fair value measurements. Significant fair value measures are subject to detailed analytics and management review and approval. Our entire investment portfolio is priced by third-party brokers at the “bid side” of the market, and/or by independent pricing providers. We strive to obtain multiple market data points for each valuation. By utilizing “bid side” pricing, certain assets, especially the most recent purchases, may realize a markdown due to the “bid-offer” spread. To the extent that this occurs, any economic effect of this would be reflected in accumulated other comprehensive income. We back test the fair value measurements provided by the pricing providers against actual performance. We also monitor the market for recent trades, market surveys, or other market information that may be used to benchmark pricing provider inputs.

Considerable judgment is used in forming conclusions and estimating inputs to our Level 3 fair value measurements. Level 3 inputs such as interest rate movements, prepayments speeds, credit losses and discount rates are inherently difficult to estimate. Changes to these inputs can have a significant effect on fair value measurements. Accordingly, there is no assurance that our estimates of fair value are indicative of the amounts that would be realized on the ultimate sale or exchange of these assets.

Market Conditions and Outlook

The first three months of 2012 continued to produce a number of regulatory actions in an effort to stabilize economic conditions and increase liquidity in the financial markets as well as other actions related to the fall-out from the financial and foreclosure crises. Regulatory actions that could impact the value of our RMBS, either positively or negatively, include attempts by the Obama Administration to streamline further the refinancing process to allow more borrowers to refinance into lower interest rate mortgage loans (see President Obama's address in early January); the possibility of an REO to Rental program supported by the GSEs; an expansion of the HAMP refinancing program to include borrowers whose loans are not in GSE pools; and the Federal Reserve's Operation Twist. Additionally, the proposed settlement between mortgage servicers and the State Attorneys General over improper foreclosure and servicing practices contrasted with continued delays in the foreclosure process as servicers determine the impact of the proposed settlement on their operations and lackluster improvement in the employment numbers illustrate the ongoing struggle of the housing market as it begin its recovery. Events such as these will continue to impact, some to the benefit and some to the detriment, of our portfolio for an undetermined period of time.

We believe our blended Agency and non-Agency strategies and our investing expertise will allow us to better navigate the dynamic characteristics of the RMBS environment while GSE reform and any other future regulatory efforts take shape. Having a diversified portfolio allows us to mitigate risks, including the volatility and impacts generated by uncertainty in interest rates and changes in prepayments, home prices and homeowner default rates.

We expect that the majority of our assets will remain in whole-pool Agency RMBS in light of the long-term attractiveness of the asset class and in order to continue to satisfy the requirements of our exemption from registration under the 1940 Act. Interest-only Agency securities also provide a complementary investment and risk-management

strategy to our principal and interest Agency RMBS investments. Risk-adjusted returns in our Agency RMBS portfolio may decline if we are required to pay higher purchase premiums due to lower interest rates or additional liquidity in the market.

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The following table provides the carrying value of our RMBS portfolio by product type:

| (dollars in thousands) | March 31, 2012 | | December 31, 2011 | | |
|--------------------------|-------------------|------|----------------------|------|---|
| Agency | | | | | |
| Fixed Rate | \$7,000,442 | 76.3 | % \$4,821,479 | 77.2 | % |
| Hybrid ARMs | 227,164 | 2.5 | % 231,678 | 3.7 | % |
| Total Agency | 7,227,606 | 78.8 | % 5,053,157 | 80.9 | % |
| Non-Agency | | | | | |
| Senior | 1,563,689 | 17.0 | % 932,867 | 14.9 | % |
| Mezzanine | 376,050 | 4.1 | % 262,633 | 4.2 | % |
| Interest-only securities | 4,166 | 0.1 | % 595 | — | % |
| Total Non-Agency | 1,943,905 | 21.2 | % 1,196,095 | 19.1 | % |
| Total | \$9,171,511 | | \$6,249,252 | | |

Prepayment speeds and volatility due to interest rates

Our Agency RMBS portfolio is subject to inherent prepayment risk: generally, a decline in interest rates that leads to rising prepayment speeds will cause the market value of our interest-only securities to deteriorate, but will cause the market value of our fixed coupon Agency pools to increase. The inverse relationship occurs when interest rates increase and prepayments slow. We do not expect housing prices to fully stabilize in 2012 and this, combined with elevated unemployment rates and housing inventory increases, leads us to expect that there will not be a significant increase in prepayment speeds in 2012. However, given the low level of interest rates, the implementation of Operation Twist, and the announcement of HARP 2.0, the revamped Home Affordable Refinance Program, or other potential government programs, it is possible that prepayment speeds will increase on many RMBS, which could lead to less attractive reinvestment opportunities. Nonetheless, we believe our portfolio approach, including our security selection process, is well positioned to respond to a variety of market scenarios, including an overall faster prepayment environment.

Although we are unable to predict the movement in interest rates for the remainder of 2012 and beyond, our blended Agency and non-Agency portfolio strategy is intended to generate attractive yields with a low level of sensitivity to yield curve, prepayments and interest rate cycles.

Our portfolio includes Agency securities, which includes bonds with explicit prepayment protection, low loan balances (securities collateralized by loans of less than \$175,000 in principal), high LTV ratios (securities collateralized by loans with greater or equal to 80% LTV), low FICO scores (lower credit borrowers), home equity conversion mortgages (securities collateralized by reverse mortgages), and seasoned bonds reflecting less prepayment risk due to previously experienced high levels of refinancing. We believe these bond characteristics reduce the prepayment risk to the portfolio.

The following tables provide the carrying value of our Agency RMBS portfolio by vintage and prepayment protection:

| (dollars in thousands) | As of March 31, 2012 | | | | |
|---|----------------------|-------------|-------------------|----|---|
| | Fixed Rate | Hybrid ARMs | Total Agency RMBS | | |
| Lower loan balances | \$3,451,329 | \$— | \$3,451,329 | 48 | % |
| Home equity conversion mortgages | 1,269,970 | — | 1,269,970 | 17 | % |
| High LTV | 775,954 | — | 775,954 | 11 | % |
| Seasoned (2005 and prior vintages) | 563,186 | 142,226 | 705,412 | 10 | % |
| Pre-pay lock-out or penalty-based | 477,896 | 34,823 | 512,719 | 7 | % |
| Low FICO | 258,226 | — | 258,226 | 4 | % |
| 2006 and subsequent vintages | 200,318 | 50,115 | 250,433 | 3 | % |
| 2006 and subsequent vintages - discount | 3,563 | — | 3,563 | — | % |

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| | | | | | |
|-------|-------------|-----------|-------------|-----|---|
| Total | \$7,000,442 | \$227,164 | \$7,227,606 | 100 | % |
| 38 | | | | | |

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| | As of December 31, 2011 | | | | |
|---|-------------------------|-------------|-------------------|-----|---|
| (dollars in thousands) | Fixed Rate | Hybrid ARMs | Total Agency RMBS | | |
| Lower loan balances | \$2,759,091 | \$— | \$2,759,091 | 55 | % |
| Home equity conversion mortgages | 939,738 | — | 939,738 | 19 | % |
| High LTV | 211,312 | — | 211,312 | 4 | % |
| Seasoned (2005 and prior vintages) | 346,624 | 146,826 | 493,450 | 10 | % |
| Pre-pay lock-out or penalty-based | 266,456 | 34,826 | 301,282 | 6 | % |
| 2006 and subsequent vintages | 123,323 | 50,026 | 173,349 | 3 | % |
| 2006 and subsequent vintages - discount | 174,935 | — | 174,935 | 3 | % |
| Total | \$4,821,479 | \$231,678 | \$5,053,157 | 100 | % |

We offset a portion of the Agency exposure to prepayment speeds through our non-Agency portfolio. Our non-Agency RMBS yields are expected to increase if prepayment rates on such assets exceed our prepayment assumptions. To the extent that prepayment speeds increase due to macroeconomic factors, we expect to benefit from the ability to recognize the income from the heavily discounted RMBS prices that principally arose from credit or payment default expectations.

The following tables provide discount information on our non-Agency RMBS portfolio:

| | As of March 31, 2012 | | | |
|---------------------------|-----------------------------------|-----------|--------------------------|-------------|
| (in thousands) | Principal and Interest securities | | Interest-Only Securities | Total |
| | Senior | Mezzanine | | |
| Face Value | \$3,426,974 | \$735,368 | \$70,905 | \$4,233,247 |
| Unamortized discount | | | | |
| Designated credit reserve | (1,170,013) | (134,740) | — | (1,304,753) |
| Unamortized net discount | (668,116) | (213,250) | (67,007) | (948,373) |
| Amortized Cost | \$1,588,845 | \$387,378 | \$3,898 | \$1,980,121 |
| | As of December 31, 2011 | | | |
| (in thousands) | Principal and Interest Securities | | Interest-Only Securities | Total |
| | Senior | Mezzanine | | |
| Face Value | \$2,104,161 | \$551,867 | \$11,901 | \$2,667,929 |
| Unamortized discount | | | | |
| Designated credit reserve | (663,890) | (118,716) | — | (782,606) |
| Unamortized net discount | (387,759) | (141,715) | (11,495) | (540,969) |
| Amortized Cost | \$1,052,512 | \$291,436 | \$406 | \$1,344,354 |

Credit losses

Although our Agency portfolio is supported by U.S. Government agency and federally chartered corporation guarantees of payment of principal and interest, we are exposed to credit risk in our non-Agency RMBS portfolio. However, the credit support built into non-Agency RMBS deal structures is designed to provide a level of protection from potential credit losses for more senior tranches. In addition, the discounted purchase prices paid on our non-Agency RMBS assets provide additional insulation from credit losses in the event we receive less than 100% of par on such assets. We evaluate credit risk on our non-Agency investments through a comprehensive asset selection process, which is predominantly focused on quantifying and pricing credit risk. We review our non-Agency RMBS based on a quantitative and qualitative analysis of the risk-adjusted returns on such investments. We evaluate each investment's credit risk through our initial modeling and scenario analysis and through on-going asset surveillance. At purchase, we estimate the portion of the discount we do not expect to recover and factor that into our expected yield and accretion methodology. We may also record an other-than-temporary impairment, or OTTI, for a portion of our investment in a security to the extent we believe that the amortized cost exceeds the present value of expected future

cash flows. Nevertheless, unanticipated credit losses could occur, adversely impacting our operating results.

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Counterparty exposure and leverage ratio

We monitor counterparty exposure in our broker, banking and lending counterparties on a daily basis. We believe our broker and banking counterparties are well capitalized organizations and we attempt to manage our cash balances across these organizations to reduce our exposure to a single counterparty.

We had entered into repurchase agreements with 20 counterparties as of March 31, 2012. As of March 31, 2012, we had a debt to equity ratio of 4.2 times. As of March 31, 2012, we had \$545.7 million in cash and cash equivalents, approximately \$23.2 million of unpledged Agency securities and derivatives and \$189.1 million of unpledged non-Agency securities and an overall estimated unused borrowing capacity on our unpledged RMBS of approximately \$131.8 million. If borrowing rates and collateral requirements change in the near term, we believe we are subject to less earnings volatility than a more levered organization.

Summary of Results of Operations and Financial Condition

Our reported GAAP net income attributable to common stockholders was \$51.8 million (\$0.28 per diluted weighted share) for the three months ended March 31, 2012 as compared to a GAAP net income attributable to common stockholders of \$22.4 million (\$0.49 per diluted weighted share) for the three months ended March 31, 2011.

On March 14, 2012, we declared a dividend of \$0.40 per diluted share. Our GAAP book value per diluted common share was \$9.67 at March 31, 2012, an increase from \$9.03 book value per diluted common share at December 31, 2011.

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The following table presents the components of our net income for the three months ended March 31, 2012 and 2011:

| (in thousands, except share data) Income Statement Data: | Three Months Ended March 31, | |
|---|----------------------------------|----------------------|
| | 2012 (unaudited) | 2011 |
| Interest income: | | |
| Available-for-sale securities | \$84,214 | \$19,535 |
| Trading securities | 1,050 | 272 |
| Mortgage loans held-for-sale | 69 | — |
| Cash and cash equivalents | 168 | 63 |
| Total interest income | 85,501 | 19,870 |
| Interest expense | 11,467 | 2,499 |
| Net interest income | 74,034 | 17,371 |
| Other-than-temporary impairments: | | |
| Total other-than temporary impairment losses | (4,275) |) — |
| Non-credit portion of loss recognized in other comprehensive income | — | — |
| Net other-than-temporary credit impairment losses | (4,275) |) — |
| Other income: | | |
| Gain on sale of investment securities, net | 9,931 | 1,539 |
| (Loss) gain on interest rate swap and swaption agreements | (16,193) |) 1,939 |
| (Loss) gain on other derivative instruments | (8,890) |) 5,347 |
| Other loss | (40) |) — |
| Total other (loss) income | (15,192) |) 8,825 |
| Expenses: | | |
| Management fees | 6,743 | 1,550 |
| Other operating expenses | 3,601 | 1,512 |
| Total expenses | 10,344 | 3,062 |
| Income before income taxes | 44,223 | 23,134 |
| (Benefit from) provision for income taxes | (7,577) |) 757 |
| Net income attributable to common stockholders | \$51,800 | \$22,377 |
| Basic and diluted earnings per weighted average common share | \$0.28 | \$0.49 |
| Dividends declared per common share | \$0.40 | \$0.40 |
| Basic and diluted weighted average number of shares of common stock | 186,855,589 | 45,612,376 |
| Balance Sheet Data: | March 31, 2012 (unaudited) | December 31, 2011 |
| Available-for-sale securities | \$9,171,511 | \$6,249,252 |
| Total assets | \$11,330,982 | \$8,100,384 |
| Repurchase agreements | \$8,693,756 | \$6,660,148 |
| Total stockholders' equity | \$2,072,173 | \$1,270,086 |

Results of Operations

The following analysis focuses on the results generated during the three months ended March 31, 2012 and 2011.

Interest Income and Average Portfolio Yield

For the three months ended March 31, 2012 and 2011, we recognized \$84.2 million and \$19.5 million, respectively, of interest income from our Agency and non-Agency RMBS portfolio. Our RMBS portfolio's average amortized cost of securities was approximately \$7.2 billion and \$1.7 billion for the three months ended March 31, 2012 and 2011,

resulting in an annualized net yield of approximately 4.7% for both periods.

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For the three months ended March 31, 2012 and 2011, we recognized \$23.0 million and \$7.8 million, respectively, of net premium amortization on our Agency RMBS, including our interest-only securities. This resulted in an overall net asset yield of approximately 3.1% for both periods, excluding inverse interest-only securities which are accounted for as derivatives. For the three months ended March 31, 2012 and 2011, we recognized \$28.9 million and \$5.4 million of accretion income from the discounts on our non-Agency portfolio resulting in an overall net yield of approximately 9.7% for both periods.

The following table presents the components of the net yield earned by investment type on our RMBS portfolio as a percentage of our average amortized cost of securities (ratios for the periods have been annualized):

| | Three Months Ended March 31, 2012 | | | Three Months Ended March 31, 2011 | | |
|-------------------------------------|-----------------------------------|------------|--------------|-----------------------------------|------------|--------------|
| | Agency | Non-Agency | Consolidated | Agency | Non-Agency | Consolidated |
| Gross Yield/Stated Coupon | 4.8 | 2.9 | 4.3 | 5.6 | 4.3 | 5.3 |
| Net (Premium Amortization)/Discount | (1.7) | 6.8 | 0.4 | (2.5) | 5.4 | (0.6) |
| Accretion | | | | | | |
| Net Yield ⁽¹⁾ | 3.1 | 9.7 | 4.7 | 3.1 | 9.7 | 4.7 |

(1) These yields have not been adjusted for cost of delay and cost to carry purchase premiums.

The following table provides the components of interest income and net asset yield by investment type on our RMBS portfolio:

| (dollars in thousands) | Three Months Ended March 31, 2012 | | | Three Months Ended March 31, 2011 | | |
|-------------------------------------|-----------------------------------|-------------|-------------|-----------------------------------|------------|-------------|
| | Agency | Non-Agency | Total | Agency | Non-Agency | Total |
| Average amortized cost | \$5,514,238 | \$1,685,934 | \$7,200,172 | \$1,274,928 | \$393,387 | \$1,668,315 |
| Coupon interest | 66,179 | 12,110 | 78,289 | 17,749 | 4,253 | 22,002 |
| Net (premium amortization)/discount | (22,972) | 28,897 | 5,925 | (7,843) | 5,376 | (2,467) |
| accretion | | | | | | |
| Interest income | \$43,207 | \$41,007 | \$84,214 | \$9,906 | \$9,629 | \$19,535 |
| Net asset yield | 3.1 | 9.7 | 4.7 | 3.1 | 9.7 | 4.7 |

For the three months ended March 31, 2012 and 2011, we recognized \$1.0 million and \$0.3 million of interest income associated with our trading U.S. Treasuries, or approximately 0.4% annualized net yield on average amortized cost for both periods.

Interest Expense and the Cost of Funds

For the three months ended March 31, 2012 and 2011, we recognized \$10.6 million and \$2.3 million, respectively, in interest expense on our borrowed funds collateralized by RMBS. For the same periods, our average outstanding balance under repurchase agreements to fund RMBS was approximately \$6.2 billion and \$1.5 billion, respectively. The increase from the prior year was due to our increased capital base. The average cost of funds for the three months ended March 31, 2012 and 2011 was 0.7% and 0.6%, respectively.

For the three months ended March 31, 2012 and 2011, we recognized \$0.8 million and \$0.2 million, respectively, of interest expense associated with the financing of our U.S. Treasuries and Agency inverse interest-only derivatives, or an average cost of funds of approximately 0.3% and 0.4%, respectively. The additional funds borrowed during the three months ended March 31, 2012 resulted in an overall debt-to-equity ratio of 4.2:1.0, including the borrowings to fund the U.S. Treasuries.

Net Interest Income

For the three months ended March 31, 2012 and 2011, net interest income on our RMBS AFS portfolio was \$73.6 million and \$17.2 million, respectively, resulting in a net interest spread of approximately 4.0% and 4.1%.

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The following table provides the interest income and expense incurred in the three months ended March 31, 2012 and 2011:

| (dollars in thousands) | Three Months Ended March 31, 2012 | | | Three Months Ended March 31, 2011 | | | |
|---|-----------------------------------|-------------|-------------|-----------------------------------|------------|-------------|---|
| | Agency ⁽¹⁾ | Non-Agency | Total | Agency ⁽¹⁾ | Non-Agency | Total | |
| Average available-for-sale securities held ⁽²⁾ | | | | | | | |
| Total interest income | \$5,514,238 | \$1,685,934 | \$7,200,172 | \$1,274,928 | \$393,387 | \$1,668,315 | |
| Yield on average investment securities | 3.1 | % 9.7 | % 4.7 | % 3.1 | % 9.7 | % 4.7 | % |
| Average balance of repurchase agreements | \$5,363,466 | \$883,183 | \$6,246,649 | \$1,214,210 | \$260,005 | \$1,474,215 | |
| Total interest expense ^{(3) (4)} | \$5,544 | \$5,105 | \$10,649 | \$1,044 | \$1,247 | \$2,291 | |
| Average cost of funds ⁽⁴⁾ | 0.4 | % 2.3 | % 0.7 | % 0.3 | % 1.9 | % 0.6 | % |
| Net interest income | \$37,663 | \$35,902 | \$73,565 | \$8,862 | \$8,382 | \$17,244 | |
| Net interest rate spread | 2.7 | % 7.4 | % 4.0 | % 2.8 | % 7.8 | % 4.1 | % |

Excludes inverse interest-only securities which are classified as derivatives under U.S. GAAP. For the three (1) months ended March 31, 2012 and 2011, our average annualized yield on our Agency RMBS, including inverse interest-only securities, was 3.5% and 3.9%, respectively.

(2) Excludes change in realized and unrealized gains/(losses).

(3) Cost of funds by investment type is based on the underlying investment type of the RMBS AFS assigned as collateral.

Cost of funds does not include the accrual and settlement of interest associated with interest rate swaps. In accordance with GAAP, those costs are included in loss on interest rate swap and swaption agreements in the (4) condensed consolidated statements of comprehensive income. For the three months ended March 31, 2012 and 2011, our average cost of funds, including interest spread expense associated with interest rate swaps and including inverse interest-only securities (see footnote 1 above), was 1.0% and 1.4%, respectively.

Other-Than-Temporary Impairments

We review each of our securities on a quarterly basis to determine if an OTTI charge is necessary. For the three months ended March 31, 2012 we recognized \$4.3 million of OTTI losses, while we did not recognize any losses in the three months ended March 31, 2011. For further information about evaluating AFS securities for other-than-temporary impairments, refer to Note 3 - Available-for-Sale Securities, at Fair Value of the Notes to the Condensed Consolidated Financial Statements.

Gain on Investment Securities, Net

During the three months ended March 31, 2012, we sold AFS and trading securities for \$170.1 million with an amortized cost of \$159.0 million, for a net realized gain of \$11.1 million. During the three months ended March 31, 2011, we sold AFS and trading securities for \$270.9 million with an amortized cost of \$269.8 million, for a net realized gain of \$1.1 million, which included sales of U.S. Treasuries with an amortized cost of \$200.0 million. We do not expect to sell assets on a frequent basis, but may sell assets to reallocate capital into new assets that our management believes have higher risk-adjusted returns.

During the three months ended March 31, 2012, we recognized unrealized losses on our U.S. Treasury trading securities held as of March 31, 2012 of \$1.2 million. During the three months ended March 31, 2011, we recognized unrealized gains on our U.S. Treasury trading securities held as of March 31, 2011 of \$0.4 million.

(Loss) Gain on Interest Rate Swap and Swaption Agreements

For the three months ended March 31, 2012 and 2011, we recognized \$4.7 million and \$3.2 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with our interest rate swaps. The expenses result from generally paying a fixed interest rate on an average \$6.4 billion and \$1.3 billion notional, respectively, to hedge a portion of our interest rate risk on our short-term repurchase agreements, funding costs, and macro-financing risk and generally receiving LIBOR interest.

During the three months ended March 31, 2012 and 2011, we terminated or had options expire on 11 and 4 interest rate swap and swaption positions of \$0.9 billion notional and \$0.4 billion notional, respectively. Upon settlement of the early terminations and option expirations, we paid \$0.5 million and \$0.4 million, in 2012 and 2011 respectively, in full settlement of our net interest spread liability and recognized \$11.3 million in realized losses and \$1.3 million in realized gains on the swaps and swaptions in 2012 and 2011, respectively, including early termination penalties. We elected to terminate the swaps to reduce our cost of financing and align with our investment portfolio.

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Also included in our financial results for the three months ended March 31, 2012 and 2011 was the recognition of a change in unrealized valuation losses of \$0.2 million and unrealized valuation gains of \$3.8 million, respectively, on our interest rate swap and swaption agreements that were accounted as trading instruments. The overall decline in the swap rate curve during the three months ended March 31, 2012 resulted in unfavorable market value movement over the three month period. Since these swaps and swaptions are used for purposes of hedging our interest rate exposure, their unrealized valuation losses are generally offset by unrealized gains in our Agency RMBS portfolio, which are recorded directly to stockholders' equity through other comprehensive income.

The following table provides the net interest spread and gains and losses associated with our interest rate swap and swaption positions:

| (in thousands) | Three Months Ended March 31, | |
|---|------------------------------|------------|
| | 2012 | 2011 |
| Net interest spread | \$(4,716 |) \$(3,152 |
| Early termination and option expiration losses | (11,265 |) 1,253 |
| Change in unrealized (loss) gain on interest rate swap and swaption agreements, at fair value | (212 |) 3,838 |
| (Loss) gain on interest rate swap and swaption agreements | \$(16,193 |) \$1,939 |

(Loss) Gain on Other Derivative Instruments

Included in our financial results for the three months ended March 31, 2012 and 2011 was the recognition of \$8.9 million of losses and \$5.3 million of gains, respectively, on other derivative instruments we hold for purposes of both hedging and non-hedging activities, principally credit default swaps, TBAs and inverse interest-only securities. Included within these three months ended March 31, 2012 and 2011 results, we recognized \$6.7 million and \$2.9 million of interest income, net of accretion on inverse interest-only securities on an average amortized cost basis of \$185.8 million and \$53.3 million, respectively. The remainder represented realized and unrealized net gains on other derivative instruments. As these derivative instruments are considered trading instruments, our financial results include both realized and unrealized gains (losses) associated with these instruments.

Other Loss

For the three months ended March 31, 2012, we recorded a loss of \$40,009 which included loss on valuation of loans held-for-sale offset by rental income on investments in real estate. We did not hold mortgage loans and investments in real estate for the three months ended March 31, 2011.

Expenses**Management Fees**

We incurred management fees of \$6.7 million and \$1.6 million for the three months ended March 31, 2012 and 2011, which are payable to PRCM Advisers under our management agreement. The management fee is calculated based on our stockholders' equity.

Other Operating Expenses

For the three months ended March 31, 2012 and 2011, we recognized \$3.6 million and \$1.5 million, respectively, of other operating expenses, which represents an annualized expense ratio of 0.8% and 1.3% of average equity for the respective periods. The favorable decrease of our operating expense ratio resulted primarily from the additional capital raised upon completion of our public common stock offerings. See Note 13 - Stockholders' Equity of the notes to the condensed consolidated financial statements.

Included in these other operating expenses are direct and allocated costs incurred by PRCM Advisers on our behalf and reimbursed by us. For the three months ended March 31, 2012, these direct and allocated costs totaled approximately \$4.4 million, of which approximately \$3.4 million was expensed and approximately \$0.5 million was considered prepaid and classified as other assets on the condensed consolidated balance sheet. For the three months ended March 31, 2011, these direct and allocated costs totaled approximately \$0.9 million, of which \$0.7 million was

expensed and \$0.1 million was considered prepaid and classified as other assets on the condensed consolidated balance sheet. Approximately \$0.5 million in out-of-pocket expenses was charged against equity as a cost of raising capital for the three months ended March 31, 2012, compared to \$0.1 million for the same period in 2011. Included in these reimbursed costs was compensation paid to our executive officers, including our principal financial officer and general counsel of \$0.1 million for the three months ended March 31, 2012 and \$45,686 for the three months ended March 31, 2011. The allocation of compensation paid to our principal financial officer and general counsel is based on time spent overseeing our company's activities in

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accordance with the management agreement. Also included in other operating expense for the three months ended March 31, 2012 is real estate expenses related to our residential real property investments.

Income Taxes

For the three months ended March 31, 2012, we recognized \$7.6 million, in income tax benefit related to both current and deferred income tax provisions in our TRSs. Our effective tax rate for the three months ended March 31, 2012 was a negative 17.1%. For the three months ended March 31, 2012, we recognized \$1.3 million of deferred tax expense related to unrealized gains on derivative instruments, \$0.4 million of deferred tax benefit related to unrealized losses on U.S. Treasuries, and \$0.1 million of deferred tax benefit related to capitalized start-up and organizational costs. For the three months ended March 31, 2012, we recognized current federal tax benefit of \$8.4 million due primarily to realized net losses on derivative instruments.

For the three months ended March 31, 2011, we recognized \$0.8 million in income tax expense related to both current and deferred income tax provisions in our TRSs. Our effective tax rate for the three months ended March 31, 2011 was 3.3%. For the three months ended March 31, 2011, we recognized \$0.4 million of deferred tax expense related to unrealized gains on derivative instruments and \$0.1 million of deferred tax expense related to unrealized gains on US Treasuries. For the three months ended March 31, 2011, we have recognized current federal tax expense of \$0.3 million due to realized net gains on derivative instruments and U.S. Treasuries.

We currently intend to distribute 100% of our REIT taxable income and comply with all requirements to continue to qualify as a REIT, and therefore we have not recognized any further federal or state tax provisions.

Financial Condition**Available-for-Sale Securities, at Fair Value****Agency RMBS**

Our Agency RMBS portfolio is comprised of adjustable rate and fixed rate mortgage-backed securities backed by single-family and multi-family mortgage loans. All of our principal and interest Agency RMBS were Fannie Mae or Freddie Mac mortgage pass-through certificates or collateralized mortgage obligations that carry an implied "AAA" rating, or Ginnie Mae mortgage pass-through certificates, which are backed by the guarantee of the U.S. Government. The majority of these securities consist of whole pools in which we own all of the investment interests in the securities.

The table below summarizes certain characteristics of our Agency AFS securities at March 31, 2012:

| March 31, 2012 | | | | | | | | |
|---|------------------------|------------------------|----------------|-----------------|-----------------|----------------|------------------------------|---------------------------------|
| (dollars in thousands, except purchase price) | Principal/Current Face | Net (Discount)/Premium | Amortized Cost | Unrealized Gain | Unrealized Loss | Carrying Value | Weighted Average Coupon Rate | Weighted Average Purchase Price |
| Principal and interest securities: | | | | | | | | |
| Fixed | \$6,334,577 | \$442,396 | \$6,776,973 | \$136,269 | \$(9,172) | \$6,904,070 | 4.57 % | \$107.54 |
| Hybrid/ARM | 211,522 | 11,743 | 223,265 | 4,053 | (154) | 227,164 | 4.32 % | \$106.67 |
| Total P&I Securities | 6,546,099 | 454,139 | 7,000,238 | 140,322 | (9,326) | 7,131,234 | 4.56 % | \$107.51 |
| Interest-only securities | | | | | | | | |
| Fixed | 529,081 | (461,579) | 67,502 | 491 | (11,593) | 56,400 | 5.26 % | \$16.29 |
| Fixed Other ⁽¹⁾ | 647,020 | (608,564) | 38,456 | 1,671 | (155) | 39,972 | 1.31 % | \$6.38 |
| Total | \$7,722,200 | \$(616,004) | \$7,106,196 | \$142,484 | \$(21,074) | \$7,227,606 | | |

(1) Fixed Other represent weighted-average coupon interest-only securities that are not generally used for our interest-rate risk management purposes. These securities pay variable coupon interest based on the weighted average of the fixed rates of the underlying loans of the security, less the weighted average rates of the applicable issued principal and interest securities.

Our three-month average constant prepayment rate, or CPR, experienced by Agency RMBS owned by us as of March 31, 2012, on an annualized basis, was 5.2%.

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The following table summarizes the number of months until the next re-set for our floating or adjustable rate Agency RMBS mortgage portfolio at March 31, 2012:

| (in thousands) | Carrying Value |
|------------------------|----------------|
| 0-12 months | \$195,565 |
| 13-36 months | 7,103 |
| 37-60 months | 6,142 |
| Greater than 60 months | 18,354 |
| Total | \$227,164 |

Non-Agency RMBS

Our non-Agency RMBS portfolio is comprised of senior and mezzanine tranches of mortgage-backed securities. The following table provides investment information on our non-Agency RMBS as of March 31, 2012:

| As of March 31, 2012 | | | | | | | |
|------------------------------------|------------------------|------------------------------|----------------------------------|----------------|-----------------|-----------------|----------------|
| (in thousands) | Principal/current face | Accretible purchase discount | Credit reserve purchase discount | Amortized cost | Unrealized gain | Unrealized loss | Carrying value |
| Principal and interest securities: | | | | | | | |
| Senior | \$3,426,974 | \$(668,116) | \$(1,170,013) | \$1,588,845 | \$39,730 | \$(64,886) | \$1,563,689 |
| Mezzanine | 735,368 | (213,250) | (134,740) | 387,378 | 8,978 | (20,306) | 376,050 |
| Total P&I Securities | 4,162,342 | (881,366) | (1,304,753) | 1,976,223 | 48,708 | (85,192) | 1,939,739 |
| Interest-only securities | 70,905 | (67,007) | — | 3,898 | 268 | — | 4,166 |
| Total | \$4,233,247 | \$(948,373) | \$(1,304,753) | \$1,980,121 | \$48,976 | \$(85,192) | \$1,943,905 |

The majority of our non-Agency RMBS were rated at March 31, 2012. Note that credit ratings are based on the par value of the non-Agency RMBS, whereas the distressed non-Agency RMBS assets in our portfolio were acquired at a heavily discounted price. The following table summarizes the credit ratings of our non-Agency RMBS portfolio as of March 31, 2012:

| | March 31, 2012 | |
|-----------|----------------|---|
| AAA | — | % |
| AA | 0.2 | % |
| A | 0.8 | % |
| BBB | 3.4 | % |
| BB | 7.7 | % |
| B | 7.3 | % |
| Below B | 79.9 | % |
| Not rated | 0.7 | % |
| Total | 100.0 | % |

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The following tables present certain information detailed by investment type and their respective underlying loan characteristics for our senior and mezzanine non-Agency RMBS, excluding our non-Agency interest-only portfolio, at March 31, 2012:

| At March 31, 2012 | | | | |
|--|--------------|-----------------|-----------------|---|
| Non-Agency Principal and Interest (P&I) RMBS Characteristics | Senior Bonds | Mezzanine Bonds | Total P&I Bonds | |
| Carrying Value (in thousands) | \$1,563,689 | \$376,050 | \$1,939,739 | |
| % of Non-Agency Portfolio | 80.6 | % 19.4 | % 100.0 | % |
| Average Purchase Price | \$50.89 | \$56.34 | \$51.94 | |
| Average Coupon | 1.9 | % 1.1 | % 1.8 | % |
| Average Fixed Coupon | 5.5 | % 5.8 | % 5.6 | % |
| Average Floating Coupon | 1.2 | % 0.9 | % 1.1 | % |
| Average Hybrid Coupon | 4.6 | % 2.7 | % 4.6 | % |
| Collateral Attributes | | | | |
| Avg Loan Age (months) | 68 | 86 | 71 | |
| Avg Original Loan-to-Value | 78.6 | % 77.4 | % 78.4 | % |
| Avg Original FICO ⁽¹⁾ | 640 | 633 | 639 | |
| Current Performance | | | | |
| 60+ day delinquencies | 40.3 | % 32.9 | % 38.9 | % |
| Average Credit Enhancement ⁽²⁾ | 18.8 | % 32.8 | % 21.5 | % |
| 3-Month CPR ⁽³⁾ | 1.7 | % 2.4 | % 1.9 | % |

(1) FICO represents a mortgage industry accepted credit score of a borrower, which was developed by Fair Isaac Corporation.

(2) Average credit enhancement remaining on our non-Agency RMBS portfolio, which is the average amount of protection available to absorb future credit losses due to defaults on the underlying collateral.

Three-Month CPR is reflective of the prepayment speed on the underlying securitization; however, it does not necessarily indicate the proceeds received on our investment tranche. Proceeds received for each security are dependent on the position of the individual security within the structure of each deal.

| Non-Agency RMBS Characteristics (dollars in thousands) | March 31, 2012 | | | | | | |
|--|----------------|-------------------|-----------------|----------------------|----------------|---------------------------|---|
| | Senior Bonds | | Mezzanine Bonds | | Total Bonds | | |
| Loan Type | Carrying Value | % of Senior Bonds | Carrying Value | % of Mezzanine Bonds | Carrying Value | % of Non-Agency Portfolio | |
| Prime | \$24,700 | 1.5 | % \$583 | 0.2 | % \$25,283 | 1.3 | % |
| Alt-A | 66,507 | 4.3 | % 9,542 | 2.4 | % 76,049 | 4.0 | % |
| POA | 199,563 | 12.8 | % 16,377 | 4.4 | % 215,940 | 11.1 | % |
| Subprime | 1,272,919 | 81.4 | % 349,548 | 93.0 | % 1,622,467 | 83.6 | % |
| | \$1,563,689 | 100.0 | % \$376,050 | 100.0 | % \$1,939,739 | 100.0 | % |

| Non-Agency RMBS Characteristics (dollars in thousands) | March 31, 2012 | | | | | | |
|--|----------------|-------------------|-----------------|----------------------|----------------|---------------------------|--|
| | Senior Bonds | | Mezzanine Bonds | | Total Bonds | | |
| Coupon Type | Carrying Value | % of Senior Bonds | Carrying Value | % of Mezzanine Bonds | Carrying Value | % of Non-Agency Portfolio | |

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| | | | | | | | | | |
|--------------------|-------------|-------|---|-----------|-------|---|-------------|-------|---|
| Fixed Rate | \$243,428 | 15.6 | % | \$16,937 | 4.5 | % | \$260,365 | 13.4 | % |
| Hybrid or Floating | 1,320,261 | 84.4 | % | 359,113 | 95.5 | % | 1,679,374 | 86.6 | % |
| | \$1,563,689 | 100.0 | % | \$376,050 | 100.0 | % | \$1,939,739 | 100.0 | % |

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| Non-Agency RMBS Characteristics (dollars in thousands) | March 31, 2012 | | | | | | | | |
|--|-------------------|----------------------|---|-------------------|----------------------------|---|-------------------|---------------------------------|---|
| | Senior Bonds | | | Mezzanine Bonds | | | Total Bonds | | |
| Loan Origination Year | Carrying Value | % of Senior Bonds | | Carrying Value | % of Mezzanine Bonds | | Carrying Value | % of Non-Agency Portfolio | |
| 2006+ | \$1,186,178 | 75.9 | % | \$43,072 | 11.4 | % | \$1,229,250 | 63.4 | % |
| 2002-2005 | 374,601 | 24.0 | % | 329,380 | 87.6 | % | 703,981 | 36.3 | % |
| Pre-2002 | 2,910 | 0.1 | % | 3,598 | 1.0 | % | 6,508 | 0.3 | % |
| | \$1,563,689 | 100.0 | % | \$376,050 | 100.0 | % | \$1,939,739 | 100.0 | % |

Repurchase Agreements

Our borrowings consist entirely of repurchase agreements collateralized by our pledge of AFS and trading securities, derivative instruments, mortgage loans and certain cash balances. Substantially all of our Agency RMBS are currently pledged as collateral, and the majority of our non-Agency RMBS have been pledged. As of March 31, 2012, our debt-to-equity ratio was 4.2:1.0, including the debt collateralized by our U.S. Treasuries, residential mortgage loans and Agency derivatives. Our debt-to-equity ratio for RMBS, residential mortgage loans and Agency derivatives only was 3.7:1.0. We believe our debt-to-equity ratio provides unused borrowing capacity and, thus, improves our liquidity and the strength of our balance sheet.

As of March 31, 2012, the term to maturity of our borrowings ranged from one day to over twenty months. The weighted average original term to maturity of our borrowings collateralized by RMBS and mortgage loans was 80 days at March 31, 2012. At March 31, 2012, the weighted average cost of funds for all our repurchase agreements was 0.63%.

| (dollars in thousands) | March 31, 2012 | | | December 31, 2011 | | |
|------------------------------|----------------|----------|---|-------------------|----------|---|
| Collateral Type | Amount | Weighted | | Amount | Weighted | |
| | Outstanding | Average | | Outstanding | Average | |
| U.S. Treasuries | \$ 1,001,250 | 0.20 | % | \$ 1,001,250 | 0.12 | % |
| Agency RMBS | 6,499,814 | 0.43 | % | 4,804,533 | 0.50 | % |
| Non-Agency RMBS | 1,009,353 | 2.29 | % | 731,014 | 2.61 | % |
| Agency derivatives | 178,048 | 1.14 | % | 118,032 | 0.97 | % |
| Mortgage loans held-for-sale | 5,291 | 3.14 | % | 5,319 | 3.20 | % |
| Total | \$8,693,756 | 0.63 | % | \$6,660,148 | 0.68 | % |

As of March 31, 2012, the Company's amounts outstanding under repurchase agreements includes \$96.3 million of borrowings under the 364-day repurchase facility with Wells Fargo Bank National Association, or Wells Fargo. As of March 31, 2012, the facility provided an aggregate maximum borrowing capacity of \$150.0 million and is set to mature on July 25, 2012. The facility is collateralized by non-Agency RMBS and its weighted average borrowing rate as of March 31, 2012 was 1.98%. As of December 31, 2011, the Company's amounts outstanding under repurchase agreements included \$130.0 million of borrowings under the 364-day repurchase facility with Wells Fargo. As of December 31, 2011, the facility provided an aggregate maximum borrowing capacity of \$150.0 million. The facility was collateralized by non-Agency RMBS and its weighted average borrowing rate as of December 31, 2011 was 2.07%.

As of March 31, 2012, the Company's amounts outstanding under repurchase agreements included \$5.3 million of borrowings under the 364-day repurchase facility with Barclays Bank PLC, or Barclays. The facility provides an aggregate maximum borrowing capacity of \$100.0 million and is set to mature on May 16, 2012, unless extended pursuant to its terms. The facility is collateralized by eligible residential mortgage loans and its weighted average borrowing rate as of March 31, 2012 was 3.14%. As of December 31, 2011, the Company's amounts outstanding

under repurchase agreements included \$5.3 million of borrowings under the 364-day repurchase facility with Barclays Bank PLC, or Barclays. As of December 31, 2011, the facility provided an aggregate maximum borrowing capacity of \$100.0 million. The facility was collateralized by eligible residential mortgage loans and its weighted average borrowing rate as of December 31, 2011 was 3.20%.

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The following table provides the quarterly average balances, the quarter-end balances, and the maximum balances at any month-end within that quarterly period, of repurchase agreements for the three months ended March 31, 2012, and the four immediately preceding quarters:

| (dollars in thousands) | Quarterly Average Repurchase Balances ⁽¹⁾ | End of Period Balance Repurchase Agreements ⁽¹⁾ | Maximum Balance of Any Month-End for Repurchase Agreements ⁽¹⁾ | Repurchase Agreements to Equity Ratio | |
|---|---|---|--|---|-----|
| For the Three Months Ended March 31, 2012 | 6,390,647 | 7,692,506 | 7,692,506 | 3.7:1.0 | (2) |
| For the Three Months Ended December 31, 2011 | 5,694,818 | 5,658,898 | 5,766,848 | 4.5:1.0 | |
| For the Three Months Ended September 30, 2011 | 4,640,801 | 5,771,063 | 5,771,063 | 4.4:1.0 | (3) |
| For the Three Months Ended June 30, 2011 | 3,050,424 | 3,807,802 | 3,807,802 | 4.2:1.0 | (4) |
| For the Three Months Ended March 31, 2011 | 1,516,076 | 2,317,156 | 2,317,156 | 3.4:1.0 | (5) |

(1) Includes repurchase agreements collateralized by RMBS, residential mortgage loans and Agency derivatives and excludes repurchase agreements collateralized by U.S. Treasuries.

On January 17, 2012 and February 24, 2012, we completed capital raises of approximately \$354.5 million and \$337.4 million, respectively in net proceeds, which were invested on a leveraged basis. With a higher targeted allocation to non-Agency RMBS for additional capital, we targeted a fully deployed debt-to-equity ratio of 4.0:1.0 to 4.5:1.0.

On July 15, 2011, we completed a capital raise of approximately \$483.6 million in net proceeds, which were invested on a leveraged basis. With a higher targeted allocation to non-Agency RMBS for additional capital, we targeted a fully deployed debt-to-equity ratio of 4.0:1.0 to 4.5:1.0.

On May 25, 2011, we completed a capital raise of approximately \$235.2 million in net proceeds, which were invested on a leveraged basis. With a higher targeted allocation to non-Agency RMBS for additional capital, we targeted a fully deployed debt-to-equity ratio of 4.0:1.0 to 4.5:1.0.

On March 16, 2011, we completed a capital raise of approximately \$287.8 million in net proceeds. Due to the timing of the capital raise within the quarter, the net proceeds were not fully invested, on a leveraged basis, until the end of April 2011. With a higher targeted allocation to Agency RMBS for additional capital, we targeted a fully deployed debt-to-equity ratio of 4.5:1.0 to 5.0:1.0.

Equity

As of March 31, 2012, our stockholders' equity was \$2.1 billion and our diluted book value per share was \$9.67. As of December 31, 2011, our stockholders' equity was \$1.3 billion and our diluted book value per share was \$9.03.

The following table provides details of our changes in stockholders' equity from December 31, 2011 to March 31, 2012:

| (dollars in thousands, except per share amounts) | Book Value | Book Value Per Diluted Share ⁽²⁾ |
|---|--------------|--|
| Stockholders' equity at December 31, 2011 | \$ 1,270,086 | \$9.03 |
| GAAP net income: | | |
| Core Earnings, net of tax benefit of \$0.8 million ⁽¹⁾ | 63,731 | 0.30 |
| Realized gains and losses, net of tax benefit of \$3.1 million | (1,947) |) (0.01) |
| Unrealized mark-to-market gains and losses, net of tax benefit of \$3.7 million | (9,984) |) (0.05) |
| Other comprehensive income | 143,910 | 0.67 |
| Dividend declaration | (85,683) |) (0.40) |
| Net proceeds from common stock issuance | 692,000 | 0.13 |

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| | | |
|--|-------------|--------|
| Other | 60 | — |
| Stockholders' equity at March 31, 2012 | \$2,072,173 | \$9.67 |

Core Earnings is a non-GAAP measure that we define as net income, excluding impairment losses, gains or losses on sales of securities and termination of interest rate swaps, unrealized gains or losses on trading securities, interest (1)rate swaps and swaptions and certain gains or losses on other derivative instruments. As defined, Core Earnings includes interest income associated with our inverse interest-only securities, or Agency derivatives, and premium income on credit default swaps. Core Earnings is provided for purposes of comparability to other peer issuers. (2)Diluted shares outstanding at end of period are used as the denominator in book value per share calculation.

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Liquidity and Capital Resources

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

Our principal sources of cash consist of borrowings under repurchase agreements, payments of principal and interest we receive on our RMBS portfolio, cash generated from our operating results, and proceeds from capital market transactions. We typically use cash to repay principal and interest on our repurchase agreements, to purchase our target assets, to make dividend payments on our capital stock, and to fund our operations.

To the extent that we raise additional equity capital through capital market transactions, we anticipate using cash proceeds from such transactions to purchase additional RMBS, mortgage loans, residential properties and other target assets and for other general corporate purposes. There can be no assurance, however, that we will be able to raise additional equity capital at any particular time or on any particular terms.

As of March 31, 2012, we held \$545.7 million in cash and cash equivalents available to support our operations, \$10.5 billion of AFS, trading securities and derivative assets held at fair value, and \$8.7 billion of outstanding debt in the form of repurchase agreements (excludes \$413.1 million in payables to broker counterparties for unsettled security purchases). During the three months ended March 31, 2012, our debt-to-equity ratio decreased from 5.2:1.0 to 4.2:1.0, including monies borrowed to finance our investment in U.S. Treasuries. The debt-to-equity ratio funding our RMBS, residential mortgage loans, and Agency derivatives decreased from 4.5:1.0 to 3.7:1.0 as we continued to deploy capital from our offering proceeds. We believe the debt-to-equity ratio funding our RMBS, residential mortgage loans and Agency derivatives is the most meaningful debt-to-equity measure as U.S. Treasuries are viewed to be highly liquid in nature.

As of March 31, 2012, we had approximately \$23.2 million of unpledged Agency securities and derivatives and \$189.1 million of unpledged non-Agency securities and an overall estimated unused borrowing capacity on unpledged RMBS of approximately \$131.8 million. On a daily basis, we monitor and forecast our available, or excess, liquidity. Additionally, we frequently perform shock analyses against various market events to monitor the adequacy of our excess liquidity. If borrowing rates and collateral requirements change in the near term, we believe we are subject to less earnings volatility than a more leveraged organization.

We have not experienced any restrictions to our funding sources in 2012 and have generally experienced an increase in available financing in the RMBS marketplace. We expect ongoing sources of financing to be primarily repurchase agreements and similar financing arrangements. We plan to finance our assets with a moderate amount of leverage, the level of which may vary based upon the particular characteristics of our portfolio and market conditions. We may deploy, on a debt-to-equity basis, up to ten times leverage on our Agency RMBS assets. We also deploy some leverage on our non-Agency RMBS assets utilizing repurchase agreements as the source of financing.

As of March 31, 2012, we have master repurchase agreements in place with 20 counterparties, the majority of which are U.S. domiciled financial institutions, and we continue to evaluate further counterparties to manage and reduce counterparty risk. Under our repurchase agreements, we are required to pledge additional assets as collateral to our counterparties (lenders) when the estimated fair value of the existing pledged collateral under such agreements declines and such lenders, through a margin call, demand additional collateral. Lenders generally make margin calls because of a perceived decline in the value of our assets collateralizing the repurchase agreements. This may occur following the monthly principal reduction of assets due to scheduled amortization and prepayments on the underlying mortgages, or may be caused by changes in market interest rates, a perceived decline in the market value of the investments and other market factors. To cover a margin call, we may pledge additional securities or cash. At maturity, any cash on deposit as collateral is generally applied against the repurchase agreement balance, thereby reducing the amount borrowed. Should the value of our assets suddenly decrease, significant margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

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The following table summarizes our repurchase agreements and counterparty geographical concentration at March 31, 2012 and December 31, 2011:

| | March 31, 2012 | | | | December 31, 2011 | | |
|------------------------|--------------------|--|--------------------|--|--------------------|--|--------------------|
| (dollars in thousands) | Amount Outstanding | Net Counterparty Exposure ⁽¹⁾ | Percent of Funding | | Amount Outstanding | Net Counterparty Exposure ⁽¹⁾ | Percent of Funding |
| North America | \$6,327,192 | \$802,893 | 63.0 % | | \$4,972,632 | \$570,534 | 71.3 % |
| Europe ⁽²⁾ | 1,282,125 | 406,498 | 31.9 % | | 884,888 | 183,955 | 23.0 % |
| Asia ⁽²⁾ | 1,084,439 | 65,561 | 5.1 % | | 802,628 | 45,954 | 5.7 % |
| Total | \$8,693,756 | \$1,274,952 | 100.0 % | | \$6,660,148 | \$800,443 | 100.0 % |

Represents the net carrying value of the securities or mortgage loans sold under agreements to repurchase, including accrued interest plus any cash or assets on deposit to secure the repurchase obligation, less the amount of (1) the repurchase liability, including accrued interest. At March 31, 2012 and December 31, 2011, we had \$413.1 million and \$45.6 million, respectively, in payables due to broker counterparties for unsettled security purchases.

The payables are not included in the amounts presented above.

(2) Exposure to European and Asian domiciled banks and their U.S. subsidiaries.

For the three months ended March 31, 2012, we continued to maintain our repurchase agreement with Wells Fargo Bank. The repurchase agreement serves as a repurchase facility used from time to time to finance certain of our non-Agency securities held in our RMBS portfolio with Wells Fargo. As of March 31, 2012, borrowings under the Wells Fargo repurchase agreement were \$96.3 million and unused, uncommitted capacity was \$53.7 million, for an aggregate maximum borrowing capacity of \$150.0 million. The facility is set to mature on July 25, 2012.

Once an RMBS is financed by Wells Fargo in accordance with the repurchase agreement, the financing is committed for the duration of the facility subject to similar pledged collateral and margin requirements as a standard repurchase agreement discussed above. As part of the repurchase agreement, we are subject to certain financial covenants, which we monitor and comply with on a daily basis. The extended duration of the facility and its terms provide an additional source to manage our liquidity and interest rate risk.

We also maintained our repurchase agreement with Barclays, which serves as a mortgage loan warehouse facility. This uncommitted facility provides an aggregate maximum borrowing capacity of \$100.0 million and is set to mature on May 16, 2012, unless extended pursuant to its terms. As of March 31, 2012, borrowings under the uncommitted facility were \$5.3 million and unused capacity was \$94.7 million. The facility is collateralized by eligible residential mortgage loans, which are subject to margin call provisions that provide Barclays with certain rights when there has been a decline in the market value of the purchased mortgage loans.

We are subject to the following financial covenants under the Wells Fargo and Barclays repurchase agreements, as further detailed by the guaranty agreements we entered into in connection with the repurchase agreements. The following represents the most restrictive covenant calculations as of March 31, 2012 across both agreements:

As of the last business day of each calendar quarter, Total Indebtedness to Net Worth must be less than the (a) specified Threshold Ratio in the Repurchase Agreement. As of March 31, 2012, our debt to net worth, as defined, was 3.9:1.0 while our threshold ratio, as defined, was 6.5:1.0.

As of the last business day of each calendar quarter, Liquidity must be greater than \$25 million and the aggregate amount of Unrestricted Cash or Cash Equivalents must be greater than \$15 million. As of March 31, 2012, our (b) liquidity, as defined, was \$545.7 million and our total unrestricted cash and cash equivalents, as defined, was \$285.2 million.

As of the last business day of each calendar quarter, Net Worth must be greater than \$450 million. As of March 31, (c) 2012, our net worth, as defined, was \$2.1 billion.

We are also subject to financial covenants in connection with various other International Swap and Derivative Association, or ISDA, and repurchase agreements we enter into in the normal course of our business. The covenants described above represent the most restrictive of all covenant terms under these agreements. We intend to continue to operate in a manner which complies with all of our financial covenants.

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The following table summarizes assets at carrying value that are pledged or restricted as collateral for the future payment obligations of repurchase agreements.

| (in thousands) | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Available-for-sale securities, at fair value | \$8,606,739 | \$6,160,229 |
| Trading securities, at fair value | 1,002,090 | 1,003,301 |
| Mortgage loans held-for-sale | 5,711 | 5,782 |
| Cash and cash equivalents | 10,000 | 15,000 |
| Restricted cash | 46,180 | 94,803 |
| Due from counterparties | 57,341 | 32,201 |
| Derivative assets, at fair value | 227,304 | 145,779 |
| Total | \$9,955,365 | \$7,457,095 |

Although we generally intend to hold our target assets as long-term investments, we may sell certain of our investment securities in order to manage our interest rate risk and liquidity needs, to meet other operating objectives and to adapt to market conditions. We cannot predict the timing and impact of future sales of investment securities, if any. Because many of our investment securities are financed with repurchase agreements and may be financed with credit facilities (including term loans and revolving facilities), a significant portion of the proceeds from sales of our investment securities (if any), prepayments and scheduled amortization are used to repay balances under these financing sources. The following table provides the maturities of our repurchase agreements as of March 31, 2012 and December 31, 2011:

| (in thousands) | March 31, 2012 | December 31, 2011 |
|----------------------------------|-------------------|----------------------|
| Within 30 days | \$2,081,095 | \$1,967,009 |
| 30 to 59 days ⁽¹⁾ | 1,662,224 | 1,263,060 |
| 60 to 89 days | 831,225 | 1,096,410 |
| 90 to 119 days | 1,567,329 | 359,171 |
| 120 to 364 days ⁽²⁾ | 1,470,633 | 923,248 |
| Open maturity ⁽³⁾ | 1,001,250 | 1,001,250 |
| One year and over ⁽⁴⁾ | 80,000 | 50,000 |
| Total | \$8,693,756 | \$6,660,148 |

(1) 30 to 59 days includes the amounts outstanding under the Barclays 364-day borrowing facility.

(2) 120 to 364 days includes the amounts outstanding under the Wells Fargo 364-day borrowing facility.

(3) Repurchase agreements collateralized by U.S. Treasuries include an open maturity period (i.e., rolling 1-day maturity) renewable at the discretion of either party to the agreements.

(4) One year and over includes repurchase agreements with a maturity date of December 23, 2013.

For the three months ended March 31, 2012, our unrestricted cash balance increased to \$545.7 million from \$360.0 million at December 31, 2011. The cash movements can be summarized by the following:

Cash flows from operating activities. For the three months ended March 31, 2012, operating activities increased our cash balances by approximately \$36.3 million, primarily driven by our strong interest yield and financial results for the quarter.

Cash flows from investing activities. For the three months ended March 31, 2012, investing activities reduced our cash balances by approximately \$2.5 billion. The reduction was driven by the increase in our RMBS portfolio as we deployed capital from our two public common stock offerings.

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Cash flows from financing activities. For the three months ended March 31, 2012, financing activities increased our cash balance by approximately \$2.7 billion, resulting from the net borrowings under repurchase agreements to fund our AFS portfolio as well as net proceeds of \$0.7 billion obtained from our two public common stock offerings.

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Inflation

Substantially all of our assets and liabilities are financial in nature. As a result, changes in interest rates and other factors impact our performance far more than does inflation. Our financial statements are prepared in accordance with GAAP and dividends are based upon net ordinary income and capital gains as calculated for tax purposes; in each case, our results of operations and reported assets, liabilities and equity are measured with reference to historical cost or fair value without considering inflation.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We seek to manage our risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market value while providing an opportunity to stockholders to realize attractive risk-adjusted returns through ownership of our capital stock. Although we do not seek to avoid risk completely, we believe that risk can be quantified from historical experience and we seek to manage our risk levels in order to earn sufficient compensation to justify the risks we undertake and to maintain capital levels consistent with taking such risks.

To reduce the risks to our portfolio, we employ portfolio-wide and security-specific risk measurement and management processes in our daily operations. PRCM Advisers' risk management tools include software and services licensed or purchased from third parties, in addition to proprietary software and analytical methods developed by Pine River. There can be no guarantee that these tools will protect us from market risks.

Interest Rate Risk

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and related financing obligations. 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 values of our assets.

We utilize U.S. Treasuries as well as derivative financial instruments, currently limited to interest rate swaps, swaptions, TBAs, and, to a certain extent, inverse interest-only securities, as of March 31, 2012 to hedge the interest rate risk associated with our portfolio. We seek to hedge interest rate risk with respect to both the fixed income nature of our assets and the financing of our portfolio. In hedging interest rates with respect to our fixed income assets, we seek to reduce the risk of losses on the value of our investments that may result from changes in interest rates in the broader markets. In utilizing interest rate hedges with respect to our financing, we seek to improve risk-adjusted returns and, where possible, to obtain a favorable spread between the yield on our assets and the cost of our financing. We rely on PRCM Advisers' expertise to manage these risks on our behalf. We implement part of our hedging strategy through Capitol, our TRS, which is subject to U.S. federal, state and, if applicable, local income tax.

Interest Rate Effect on Net Interest Income

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate RMBS will remain static. Moreover, interest rates may rise at a faster pace than the yields earned on our leveraged adjustable-rate and hybrid RMBS. Both of these factors could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our target assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

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

We acquire adjustable-rate and hybrid RMBS. These are assets in which some of the underlying mortgages are typically subject to periodic and lifetime interest rate caps and floors, which may limit the amount by which the security's interest yield may change during any given period. However, our borrowing costs pursuant to our financing agreements are not subject to similar restrictions. Therefore, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation, while the interest-rate yields on our adjustable-rate and hybrid RMBS could effectively be limited by caps. This issue will be magnified to the extent we acquire adjustable-rate and hybrid RMBS that are not based on mortgages that are fully indexed. In addition, adjustable-rate and hybrid RMBS may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. If this happens, we could receive less cash income on such assets than we would need to pay for interest costs on our related

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borrowings. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would harm our financial condition, cash flows and results of operations.

Interest Rate Mismatch Risk

We fund the majority of our adjustable-rate and hybrid Agency RMBS assets with borrowings that are based on LIBOR, while the interest rates on these assets may be indexed to other index rates, such as the one-year Constant Maturity Treasury index, or CMT, the Monthly Treasury Average index, or MTA, or the 11th District Cost of Funds Index, or COFI. Accordingly, any increase in LIBOR relative to these indices may result in an increase in our borrowing costs that is not matched by a corresponding increase in the interest earnings on these assets. Any such interest rate index mismatch could adversely affect our profitability, which may negatively impact distributions to our stockholders. To mitigate interest rate mismatches, we utilize the hedging strategies discussed above.

The following table provides the indices of our variable rate assets as of March 31, 2012 and December 31, 2011, respectively, based on total notional amount of bonds (dollars in thousands).

| Index Type | As of March 31, 2012 | | | Index % | As of December 31, 2011 | | | | |
|----------------------|----------------------|-----------------------|-------------|---------|-------------------------|-----------------------|-------------|---------|---|
| | Floating | Hybrid ⁽¹⁾ | Total | | Floating | Hybrid ⁽¹⁾ | Total | Index % | |
| CMT | \$— | \$169,202 | \$169,202 | 9 | % \$— | \$174,791 | \$174,791 | 14 | % |
| LIBOR | 1,664,969 | 43,083 | 1,708,052 | 89 | % 975,327 | 43,866 | 1,019,193 | 83 | % |
| Other ⁽²⁾ | 16,981 | 16,469 | 33,450 | 2 | % 16,371 | 16,337 | 32,708 | 3 | % |
| Total | \$1,681,950 | \$228,754 | \$1,910,704 | 100 | % \$991,698 | \$234,994 | \$1,226,692 | 100 | % |

(1) Hybrid amounts reflect those assets with greater than 12 months to reset.

(2) "Other" - includes COFI, MTA and other indices.

Our analysis of risks is based on PRCM Advisers' and its affiliates' experience, estimates, models and assumptions. These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of decisions by PRCM Advisers may produce results that differ significantly from the estimates and assumptions used in our models.

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We use a variety of recognized industry models, as well as proprietary models, to perform sensitivity analyses which are derived from primary assumptions for prepayment rates, discount rates and credit losses. The primary assumption used in this model is implied market volatility of interest rates. The information presented in the following interest sensitivity table projects the potential impact of sudden parallel changes in interest rates on our financial results and financial condition over the next 12 months, based on our interest sensitive financial instruments at March 31, 2012. All changes in value are measured as the change from the March 31, 2012 financial position. All projected changes in annualized net interest income are measured as the change from the projected annualized net interest income based off current performance returns.

| (dollars in thousands) | Changes in Interest Rates | | | |
|--|---------------------------|-------------|-------------|-------------|
| | -100 bps | -50 bps | +50 bps | +100 bps |
| Change in value of financial position: | | | | |
| Available-for-sale securities, at fair value | \$196,499 | \$114,125 | \$(152,157) | \$(315,634) |
| As a % of March 31, 2012 equity | 9.5 | % 5.5 | % (7.3) |)(15.2)% |
| Trading securities, at fair value | \$3,145 | \$3,145 | \$(6,072) | \$(12,145) |
| As a % of March 31, 2012 equity | 0.2 | % 0.2 | % (0.3) |)(0.6)% |
| Mortgage loans held-for-sale, at fair value | \$137 | \$57 | \$(129) | \$(345) |
| As a % of March 31, 2012 equity | — | % — | % — | % — |
| Derivatives, at fair value, net | \$(170,915) | \$(113,608) | \$134,133 | \$293,281 |
| As a % of March 31, 2012 equity | (8.2) |)(5.5)% |)(6.5)% | % 14.2 |
| Repurchase Agreements | \$(8,531) | \$(7,093) | \$7,700 | \$15,400 |
| As a % of March 31, 2012 equity | (0.4) |)(0.3)% |)(0.4)% | % 0.7 |
| Total Net Assets | \$20,335 | \$(3,374) | \$(16,525) | \$(19,443) |
| As a % of March 31, 2012 total assets | 0.2 | % — | % (0.1) |)(0.2)% |
| As a % of March 31, 2012 equity | 1.1 | % (0.1) |)(0.7)% |)(0.9)% |
| | -100 bps | -50 bps | +50 bps | +100 bps |
| Change in annualized net interest income: | \$479 | \$(2,255) | \$6,157 | \$12,314 |
| % change in net interest income | 0.1 | % (0.6) |)(1.7)% | % 3.3 |

The interest rate sensitivity table quantifies the potential changes in net interest income and portfolio value, which includes the value of swaps and our other derivatives, should interest rates immediately change. The interest rate sensitivity table presents the estimated impact of interest rates instantaneously rising 50 and 100 basis points, and falling 50 and 100 basis points. The cash flows associated with the portfolio of RMBS for each rate change are calculated based on assumptions, including prepayment speeds, yield on future acquisitions, slope of the yield curve, and size of the portfolio. Assumptions made on the interest rate sensitive liabilities, which are assumed to relate to repurchase agreements, including anticipated interest rates, collateral requirements as a percent of the repurchase agreement, amount and term of borrowing.

The AFS securities, at fair value, included in the foregoing interest rate sensitivity table under “change in value of financial position” were limited to Agency RMBS. Due to the significantly discounted prices and underlying credit risks of our non-Agency RMBS, we believe our non-Agency RMBS's valuation is inherently de-sensitized to changes in interest rates. As such, we cannot project the impact to these financial instruments and have excluded these RMBS from the interest rate sensitivity analysis. However, these non-Agency RMBS have been included in the “change in annualized net interest income” analysis.

Certain assumptions have been made in connection with the calculation of the information set forth in the foregoing interest rate sensitivity table and, as such, there can be no assurance that assumed events will occur or that other

events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at March 31, 2012. The analysis utilizes assumptions and estimates based on management's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk to maturity, future purchases and sales of assets could materially change our interest rate risk profile.

The change in annualized net interest income does not include any benefit or detriment from faster or slower prepayment rates on our Agency premium RMBS, non-Agency discount RMBS, and instruments that represent the interest payments (but not the principal) on a pool of mortgages, or interest-only securities. We anticipate that faster prepayment speeds in lower interest rate scenarios will generate lower realized yields on Agency premium and interest-only securities and higher realized yields on non-Agency discount RMBS. Similarly, we anticipate that slower prepayment speeds in

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higher interest rate scenarios will generate higher realized yields on Agency premium and interest-only bonds and lower realized yields on non-Agency discount RMBS. Although we have sought to construct the portfolio to limit the effect of changes in prepayment speeds, there can be no assurance this will actually occur, and the realized yield of the portfolio may be significantly different than we anticipate in changing interest rate scenarios.

Given the low interest rates at March 31, 2012, we applied a floor of 0% for all anticipated interest rates included in our assumptions. Because of this floor, we anticipate that any hypothetical interest rate shock decrease would have a limited positive impact on our funding costs; however, because prepayments speeds are unaffected by this floor, we expect that any increase in our prepayment speeds (occurring as a result of any interest rate decrease or otherwise) could result in an acceleration of our premium amortization on Agency and interest-only securities purchased at a premium, and accretion of discount on our non-Agency RMBS purchased at a discount. As a result, because this floor limits the positive impact of any interest rate decrease on our funding costs, hypothetical interest rate decreases could cause the fair value of our financial instruments and our net interest income to decline.

The information set forth in the interest rate sensitivity table and all related disclosures constitutes forward-looking statements within the meaning of Section 27A of the Securities Act, and Section 21E of the Exchange Act. Actual results could differ significantly from those estimated in the foregoing interest rate sensitivity table.

Prepayment Risk

Prepayment risk is the risk that principal will be repaid at a different rate than anticipated. As we receive prepayments of principal on our assets, premiums paid on such assets will be 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 assets. Conversely, discounts on such assets 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 assets.

Normally, we believe that we will be able to reinvest proceeds from scheduled principal payments and prepayments at acceptable yields; however, no assurances can be given that, should significant prepayments occur, market conditions would be such that acceptable investments could be identified and the proceeds timely reinvested.

Market Risk

Market Value Risk. Our AFS securities are reflected at their estimated fair value, with the difference between amortized cost and estimated fair value reflected in accumulated other comprehensive income. The estimated fair value of these securities fluctuates primarily due to changes in interest rates, market valuation of credit risks, and other factors. Generally, in a rising interest rate environment, we would expect the fair value of these securities to decrease; conversely, in a decreasing interest rate environment, we would expect the fair value of these securities to increase. As market volatility increases or liquidity decreases, the fair value of our assets may be adversely impacted.

Real estate risk. RMBS and residential property values are subject to volatility and may be affected adversely by a number of factors, including national, regional and local economic conditions; local real estate conditions (such as an oversupply of housing); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. Decreases in property values reduce the value of the collateral for mortgage loans and the potential proceeds available to borrowers to repay the loans, which could cause us to suffer losses on our non-Agency RMBS investments.

Liquidity Risk

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

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or exist at possibly less advantageous terms. As such, we cannot assure that we will always be able to roll over our repurchase agreements. See Item 2, "Management's Discussion and Analysis of Financial Condition and Results of

Operations - Liquidity and Capital Resources" in this Quarterly Report on Form 10-Q for further information about our liquidity and capital resource management.

Credit Risk

We believe that our investment strategy will generally keep our risk of credit losses low to moderate. However, we retain the risk of potential credit losses on all of the loans underlying our non-Agency RMBS. With respect to our non-Agency RMBS that are senior in the credit structure, credit support contained in RMBS deal structures provide a level of protection from losses. We seek to manage the remaining credit risk through our pre-acquisition due diligence process, and by factoring assumed credit losses into the purchase prices we pay for non-Agency RMBS. In addition, with respect to any particular target asset, we evaluate relative valuation, supply and demand trends, shape of yield curves, prepayment rates,

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delinquency and default rates, recovery of various sectors and vintage of collateral. At times, we enter into credit default swaps or other derivative instruments in an attempt to manage our credit risk. Nevertheless, unanticipated credit losses could adversely affect our operating results.

Item 4. Controls and Procedures

A review and evaluation was performed by our management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, of the effectiveness of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) and 15d-15(e) under the 1934 Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, were effective. Although our CEO and CFO have determined our disclosure controls and procedures were effective at the end of the period covered by this Quarterly Report on Form 10-Q, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in the reports we submit under the Securities Exchange Act of 1934.

There have been no changes in our internal control over financial reporting that occurred during the three months ended March 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

As of the date of this filing, we are not party to any litigation or legal proceedings, or to the best of our knowledge, any threatened litigation or legal proceedings, which, in our opinion, individually or in the aggregate, would have a material adverse effect on our results of operations or financial condition.

Item 1A. Risk Factors

There have been no material changes to the risk factors set forth under the heading "Item 1A. Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2011, or the Form 10-K. The materialization of any risks and uncertainties identified in our Forward Looking Statements contained in this report together with those previously disclosed in the Form 10-K or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations, and cash flows. See Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward Looking Statements" in this Quarterly Report on Form 10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
None.

Item 3. Defaults Upon Senior Securities
None.

Item 4. Mine Safety Disclosures
None.

Item 5. Other Information
None.

Item 6. Exhibits

(a) Exhibits

Exhibits - The exhibits listed on the accompanying Index of Exhibits are filed or incorporated by reference as a part of this report. Such Index is incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements 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.

TWO HARBORS INVESTMENT CORP.

Dated: May 4, 2012

By: /s/ Thomas Siering
Thomas Siering
Chief Executive Officer, President and
Director (principal executive officer)

Dated: May 4, 2012

By: /s/ Brad Farrell
Brad Farrell
Chief Financial Officer and Treasurer
(principal accounting and financial officer)

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| Exhibit Number | Exhibit Index |
|----------------|--|
| 2.1 | Agreement and Plan of Merger, dated as of June 11, 2009, by and among Capitol Acquisition Corp., Two Harbors Investment Corp., Two Harbors Merger Corp. and Pine River Capital Management L.P. (incorporated by reference to Annex A filed with Pre Effective Amendment No. 4 to the Registrant's Registration Statement on Form S-4 (File No. 333-160199) filed with the Securities and Exchange Commission ("SEC") on October 8, 2009 ("Amendment No. 4")). |
| 2.2 | Amendment No. 1 to Agreement and Plan of Merger, dated as of August 17, 2009, by and among Capitol Acquisition Corp., Two Harbors Investment Corp., Two Harbors Merger Corp. and Pine River Capital Management L.P. (incorporated by reference to Annex A-2 filed with Amendment No. 4). |
| 2.3 | Amendment No. 2 to Agreement and Plan of Merger, dated as of September 20, 2009, by and among Capitol Acquisition Corp., Two Harbors Investment Corp., Two Harbors Merger Corp. and Pine River Capital Management L.P. (incorporated by reference to Annex A-3 filed with Amendment No. 4). |
| 3.1 | Articles of Amendment and Restatement of Two Harbors Investment Corp. (incorporated by reference to Annex B filed with Amendment No. 4). |
| 3.2 | Bylaws of Two Harbors Investment Corp. (incorporated by reference to Annex C filed with Amendment No. 4). |
| 4.1 | Warrant Agreement between Continental Stock Transfer & Trust Company and Capitol Acquisition Corp. (incorporated by reference to Exhibit 4.1 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed with the SEC on March 4, 2010 ("2009 Form 10-K")). |
| 4.2 | Specimen Common Stock Certificate of Two Harbors Investment Corp. (incorporated by reference to Exhibit 4.2 to Amendment No. 4). |
| 4.3 | Specimen Warrant Certificate of Two Harbors Investment Corp. (incorporated by reference to Exhibit 4.3 filed with Pre-Effective Amendment No. 1 to the Registrant's Registration Statement on Form S-4 (File No. 333-160199) filed with the SEC on August 5, 2009). |
| 4.4 | Supplement and Amendment to Warrant Agreement between Continental Stock Transfer & Trust Company, Capitol Acquisition Corp. and Two Harbors Investment Corp. (incorporated by reference to Exhibit 4.4 to the Registrant's 2009 Form 10-K). |
| 4.5 | Second Amendment to Warrant Agreement between Two Harbors Investment Corp. and Mellon Investors Services LLC (incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed with the SEC on December 13, 2010). |
| 21.1 | Subsidiaries of registrant (filed herewith) |
| 31.1 | Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith) |
| 31.2 | Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith) |
| 32.1 | Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith) |
| 32.2 | Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith) |
| 101 | Financial statements from the Quarterly Report on Form 10-Q of Two Harbors Investment Corp. for the quarter ended March 31, 2012, filed on May 4, 2012, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Comprehensive Income, (iii) the Condensed Consolidated Statements of Stockholders' Equity and Comprehensive Income, (iv) the Condensed Consolidated Statement of Cash Flows, and (v) the Notes to the Condensed Consolidated Financial Statements. |

