

Western Asset Mortgage Capital Corp  
Form 10-Q  
August 13, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2013

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

For the transition period from      to

Commission File Number: 001-35543

**Western Asset Mortgage Capital Corporation**

(Exact name of Registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**27-0298092**  
(IRS Employer  
Identification Number)

**Western Asset Mortgage Capital Corporation**

**385 East Colorado Boulevard**

**Pasadena, California 91101**

(Address of Registrant's principal executive offices)

**(626) 844-9400**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (check one).

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller  
reporting company)

Smaller reporting company

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

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

As of August 13, 2013, there were 24,304,503 shares, par value \$0.01, of the registrant's common stock issued and outstanding.



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Table of Contents**Western Asset Mortgage Capital Corporation****Balance Sheets (Unaudited)****(in thousands except share and per share data)**

	June 30, 2013	December 31, 2012
<b>Assets:</b>		
Cash and cash equivalents	\$ 8,716	\$ 56,292
Residential mortgage-backed securities, at fair value (\$4,146,646 and \$5,043,824 pledged as collateral, at fair value, respectively)	4,186,750	5,212,581
Linked transactions, net, at fair value	1,647	
Investment related receivables	12,360	
Accrued interest receivable	15,108	17,361
Due from counterparties	134,409	54,142
Derivative assets, at fair value	118,332	24,344
Other assets	650	244
<b>Total Assets</b>	<b>\$ 4,477,972</b>	<b>\$ 5,364,964</b>
<b>Liabilities and Stockholders' Equity:</b>		
<b>Liabilities:</b>		
Borrowings under repurchase agreements	\$ 3,961,629	\$ 4,794,730
Accrued interest payable	5,887	6,561
Investment related payables	22,167	
Due to counterparties	39,000	
Derivative liabilities, at fair value	1,484	4,771
Cash overdraft payable		5,666
Accounts payable and accrued expenses	1,311	988
Underwriting and offering costs payable	8	75
Payable to related party	2,016	1,924
Dividend payable	21,878	27,041
<b>Total Liabilities</b>	<b>4,055,380</b>	<b>4,841,756</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' Equity:</b>		
Common stock, \$0.01 par value, 500,000,000 shares authorized, 24,304,503 and 24,143,944 shares issued and outstanding, respectively	243	241
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	505,957	505,454
Retained earnings (accumulated deficit)	(83,608)	17,513
<b>Total Stockholders' Equity</b>	<b>422,592</b>	<b>523,208</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 4,477,972</b>	<b>\$ 5,364,964</b>

See notes to unaudited financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation****Statement of Operations (Unaudited)**

(in thousands except share and per share data)

	For the three months ended June 30, 2013	For the six months ended June 30, 2013	For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)
<b>Net Interest Income:</b>			
Interest income	\$ 32,742	\$ 66,492	\$ 7,083
Interest expense	4,522	9,703	725
Net Interest Income	28,220	56,789	6,358
<b>Other Income (Loss):</b>			
Interest income on cash balances and other income	12	45	
Realized gain (loss) on sale of Residential mortgage-backed securities and other securities, net	(6,083)	(17,743)	1,157
Other loss on Residential mortgage-backed securities	(3,533)	(5,801)	(87)
Unrealized gain (loss) on Residential mortgage-backed securities and other securities, net	(156,286)	(211,045)	2,983
Gain on linked transactions, net	3,909	4,505	
Gain (loss) on derivative instruments, net	109,474	124,314	(5,159)
Other Income (Loss), net	(52,507)	(105,725)	(1,106)
<b>Operating Expenses:</b>			
General and administrative (includes \$251, \$537 and \$54 non-cash stock based compensation, respectively)	1,541	3,278	584
Management fee related party	1,826	3,939	407
Total Operating Expenses	3,367	7,217	991
Net income (loss) to Common Stock and participating securities	\$ (27,654)	\$ (56,153)	\$ 4,261
Net income (loss) per Common Share - Basic	\$ (1.14)	\$ (2.32)	\$ 0.41
Net income (loss) per Common Share - Diluted	\$ (1.14)	\$ (2.32)	\$ 0.41
Dividends Declared per Share of Common Stock	\$ 1.85	\$ 1.85	\$

See notes to unaudited financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation****Statement of Changes in Stockholders' Equity (Unaudited)**

(in thousands except shares and share data)

	Shares	Common Stock Par	Additional Paid- In Capital	Retained Earnings (Accumulated Deficit)	Total
Balance at December 31, 2012	24,143,944	\$ 241	\$ 505,454	\$ 17,513	\$ 523,208
Grants of restricted stock	160,559	2	(2)		
Vesting of restricted stock			505		505
Net income (loss)				(56,153)	(56,153)
Dividends on common stock				(44,968)	(44,968)
Balance at June 30, 2013	24,304,503	\$ 243	\$ 505,957	\$ (83,608)	\$ 422,592

See notes to unaudited financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation****Statement of Cash Flows (Unaudited)**

(in thousands)

	For the six months ended June 30, 2013	For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)
Cash flows from operating activities:		
Net income (loss)	\$ (56,153)	\$ 4,261
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Premium amortization and (discount accretion), net	14,199	1,567
Restricted stock amortization expense	505	54
Unrealized loss (gain) on Residential mortgage-backed securities and other securities, net	211,045	(2,983)
Mark-to-market adjustments on linked transactions	(711)	
Mark-to-market adjustments on derivative instruments	(90,303)	5,269
Other loss on Residential mortgage-backed securities	5,801	87
Realized loss (gain) on sale of Residential mortgage-backed securities and other securities, net	17,743	(1,157)
Realized loss on sale of Agency Interest-Only Strips accounted for as derivatives, net	99	
Realized loss on TBAs, net	2,563	
Realized gain on sale of swaptions, net	(1,038)	
Realized loss on expiration of option derivatives, net	925	
Realized gain on linked transaction, net	(3,748)	
Realized gain on termination of swaps	(8,895)	
Changes in operating assets and liabilities:		
Decrease (increase) in accrued interest receivable	2,253	(7,076)
Increase in other assets	(406)	(552)
Increase (decrease) in accrued interest payable	(674)	1,000
Increase in accounts payable and accrued expenses	323	432
Increase in payable to related party	92	407
Net cash provided by operating activities	93,620	1,309
Cash flows from investing activities:		
Purchase of Residential mortgage-backed securities and other securities	(1,725,304)	(2,158,676)
Purchase of securities underlying linked transactions	(76,408)	
Proceeds from sale of Residential mortgage-backed securities and other securities	2,209,607	237,390
Proceeds from sale of securities underlying linked transactions	21,733	
Principal payments and basis recovered on Residential mortgage-backed securities	156,970	8,399
Principal payments on securities underlying linked transactions	1,043	
Payment of premium for option derivatives	(4,675)	
Premium received from option derivatives	3,750	
Proceeds from gross settlement of TBAs	208,312	
Net settlements of TBAs	(2,058)	
Proceeds from sale of interest rate swaptions	16,325	
Payment of premium for interest rate swaptions	(23,544)	



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Net cash provided by (used in) investing activities	785,751	(1,912,887)
Cash flows from financing activities:		
Proceeds from issuance of common stock		160,000
Proceeds from private placements of units and common stock (concurrent with initial public offering)		45,557
Redemption of common stock		(1)
Payment of offering costs	(67)	
Proceeds from repurchase agreement borrowings	20,074,104	3,192,929
Proceeds from repurchase agreements underlying linked transactions	86,245	
Repayments of repurchase agreement borrowings	(20,907,205)	(1,456,436)
Repayments of repurchase agreements underlying linked transactions	(82,960)	
Repayment of cash overdraft	(5,666)	
Due from counterparties	(80,267)	(8,000)
Due to counterparties	39,000	4,309
Dividends on common stock	(50,131)	
Net cash provided by (used in) financing activities	(926,947)	1,938,358
Net increase (decrease) in cash and cash equivalents	(47,576)	26,780
Cash and cash equivalents beginning of period	56,292	1
Cash and cash equivalents end of period	\$ 8,716	\$ 26,781
Supplemental disclosure of operating cash flow information:		
Interest paid	\$ 11,681	\$ 446
Interest rate swaps terminated, not settled	\$ 8,895	\$
Mortgage-backed securities recorded upon unlinking of linked transactions	\$ 53,159	\$
Supplemental disclosure of non-cash financing/investing activities:		
Offering costs to be settled with related party	\$	\$ 1,200
Mortgage-backed securities sold, not settled	\$ 3,465	\$ 102,336
Mortgage-backed securities purchased, not settled	\$ (22,167)	\$ (106,019)
Mortgage-backed securities used to settle TBAs	\$ 208,817	\$
Dividends and distributions declared, not paid	\$ 21,878	\$

See notes to unaudited financial statements.

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**Western Asset Mortgage Capital Corporation**

**Notes to Financial Statements (Unaudited)**

**(in thousands - except share and per share data)**

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

**Note 1 Organization**

Western Asset Mortgage Capital Corporation (is referred to throughout this report as the Company ) is a residential real estate finance company that invests in residential mortgage assets in the United States. The Company is primarily focused on investing in, financing and managing Agency RMBS. Although the Company's core investment strategy is focused on Agency RMBS, the Company has opportunistically supplemented its portfolio with Non-Agency RMBS and may, in the future, opportunistically invest in commercial mortgage-backed securities ( CMBS ) and asset-backed securities ( ABS ).

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

At December 31, 2011 and through May 14, 2012, the Company complied with the reporting requirements for development stage enterprises and was subject to the risks associated with development stage enterprises. The Company completed its initial public offering and began its core operation on May 15, 2012. The Company incurred organizational, accounting and offering costs in connection with the Company's initial public offering (the IPO ) of its common stock and concurrent private placements. In accordance with the Management Agreement (as defined herein in Note 10) between the Company and the Manager, the Company reimbursed the Manager for \$1.2 million of offering and other related organization costs, which were paid by the Manager, from the proceeds of the IPO and concurrent private placements. The Manager paid all costs in excess of \$1.2 million. The Company ceased reporting as a development stage company on May 15, 2012.

**Note 2 Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Operations and Statements of Cash Flows**

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As previously reported in the Company's annual report on Form 10-K for 2012, during the process of preparing the Company's 2012 financial statements, the Company discovered that the methodology that was used to accrete interest income and to amortize the cost basis of certain of the Company's residential mortgage backed securities, which was based on a third party vendor's system, as well as the presentation with regard to certain items in its Statement of Cash Flows were not in accordance with GAAP. The Company has evaluated the impact of these errors and has concluded that individually and in the aggregate, these errors were not material to any previously issued financial statements. However, the Company elected to revise the Statements of Operations for the period from May 15, 2012 (commencement of operations) through June 30, 2012 and the Statements of Cash Flows for the period from May 15, 2012 (commencement of operations) through June 30, 2012 in this quarterly financial statements on Form 10-Q to correct these errors. The corrections resulted in a reclassification of a portion of the Company's previously reported net interest income to realized and unrealized gains, and certain amounts previously reflected in operating cash flows to investing cash flows (as indicated in the tables below). These revisions had no effect on net income, shareholders' equity, net change in cash, or total assets, of the Company reported for this period.

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Statements of Operations for the period from May 15, 2012 (commencement of operations) through June 30, 2012:

Amounts in thousands, except share and per share amounts	Period from May 15, 2012 (commencement of operations) through June 30, 2012		
	As Originally Reported	Adjustments	Revised
<b>Net interest income:</b>			
Interest income	\$ 6,850	\$ 233	\$ 7,083
Interest expense	725		725
Net interest income	6,125	233	6,358
<b>Other Income (loss):</b>			
Interest income on cash balances			
Realized gain on sale of residential mortgage-backed securities, net	1,120	37	1,157
Other loss on residential mortgage-backed securities	(605)	518	(87)
Unrealized gain on residential mortgage-backed securities, net	3,925	(942)	2,983
Loss on derivative instruments, net	(5,313)	154	(5,159)
Other Income, net	(873)	(233)	(1,106)
<b>Operating Expenses:</b>			
General and administrative	584		584
Management fee - related party	407		407
Total Operating Expenses	991		991
Net income available to Common Stock and Participating Securities	\$ 4,261		\$ 4,261
Earnings per share Net income attributable to common and participating shareholders (basic)	\$ 0.41	\$	\$ 0.41
Net income attributable to shareholders (diluted)	\$ 0.41	\$	\$ 0.41

Statement of Cash Flows (summarized) for the periods from May 15, 2012 (commencement of operations) through June 30, 2012:

Amounts in thousands	Period from May 15, 2012 (commencement of operations) through June 30, 2012		
	As Originally Reported	Adjustments	Revised
<b>Statement of Cash Flows (effect on individual line items)</b>			
Net income	\$ 4,261	\$	\$ 4,261
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
	2,198	(631)	1,567

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Premium amortization and (discount accretion), net			
Unrealized (gain) loss on Residential mortgage-backed securities and other securities, net	(3,925)	942	(2,983)
Mark-to-market adjustments on derivative instruments	5,409	(140)	5,269
Other loss on Residential mortgage-backed securities	605	(518)	87
Realized (gain) loss on sale of Residential mortgage-backed securities and other securities, net	(1,120)	(37)	(1,157)
All other Items	(5,735)		(5,735)
Net cash provided by operating activities	1,693	(384)	1,309
Cash flows from investing activities:			
Principal payments and basis recovered on Residential mortgage-backed securities and other securities	8,015	384	8,399
All other items	(1,921,286)		(1,921,286)
Net cash used in investing activities	(1,913,271)	384	(1,912,887)
Cash flows from financing activities:			
All items	1,938,358		1,938,358
Net cash provided by financing activities	1,938,358		1,938,358
Net increase in cash and cash equivalents	26,780		26,780
Cash and cash equivalents beginning of period	1		1
Cash and cash equivalents end of period	\$ 26,781	\$	\$ 26,781

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**Note 3 Summary of Significant Accounting Policies**

***Basis of Presentation***

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

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to present fairly the Company's financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. These financial statements should be read in conjunction with the Company's annual report on Form 10-K for the year ended December 31, 2012, filed with the Securities and Exchange Commission ( SEC ) on April 9, 2013. The results of operations for the period ended June 30, 2013 are not necessarily indicative of the results to be expected for the full year or any future period.

The Company currently operates as one business segment.

***Cash and Cash Equivalents***

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

***Classification of mortgage-backed securities and valuations of financial instruments***

***Mortgage-backed and US Treasury securities - Fair value election***

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



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***Balance Sheet Presentation***

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

***Valuation of financial instruments***

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

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

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

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

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

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



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

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

The Company determines the fair value of derivative financial instruments by obtaining quotes from a third party pricing service, whose pricing is subject to review by the Manager's pricing committee. In valuing its interest rate derivatives, such as swaps and swaptions, the Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. All of the Company's interest rate swaps are either cleared through a central clearinghouse and subject to the clearinghouse margin requirements or subject to bilateral collateral arrangements. The Company also has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association. Consequently, no credit valuation adjustment was made in determining the fair value of interest rate derivatives.

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In May 2011, the Financial Accounting Standards Board or FASB issued amendments, which were adopted by the Company, to achieve common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards. New disclosures, with a particular focus on Level III measurement are required. All transfers between Level I and Level II are required to be disclosed. There were no transfers between hierarchy levels during operations for the six months ended June 30, 2013. Information about when the current use of a non-financial asset measured at fair value differs from its highest and best use is to be disclosed.

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

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

***Interest income recognition and Impairment***

*Agency RMBS and Non-Agency RMBS rated AA and higher at the time of purchase*

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

The Company assesses its Agency RMBS and Non-Agency RMBS rated AA and higher at the time of purchase for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other than temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent that the Company can hold the security until recovery of its cost basis.

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

*Non-Agency RMBS that are purchased at a discount to par value and are rated below AA at the time of purchase and Agency Interest-Only Strips that are not classified as derivatives*

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

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

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

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

Certain of the Company's RMBS that are in an unrealized loss position at June 30, 2013 are not considered other than temporarily impaired because the Company has no intent to sell these investments, it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis and the Company is not required to sell the security for regulatory or other reasons.

*Sales of securities*

Sales of securities are driven by the Company's portfolio management process. The Company seeks to mitigate risks including those associated with prepayments and will opportunistically rotate the portfolio into securities the Company's Manager believe have more favorable attributes. Strategies may also be employed to manage net capital gains, which need to be distributed for tax purposes. Realized gains or losses on sales of securities and derivatives, inclusive of linked transactions are included in the net realized gain line item on the Statement of Operations, and are recorded at the time of disposition. The cost of positions sold is calculated using the specific identification method.

*Due from counterparties/Due to counterparties*

Due from counterparties represents cash posted with its counterparties as collateral for the Company's interest rate swaps and repurchase agreements. Due to counterparties represents cash posted with the Company by its counterparties as collateral under the Company's interest rate swaps, interest rate swaptions and repurchase agreements. In addition, Due to counterparties include non-cash collateral in which the Company has the obligation to return the collateral upon the Company either selling or pledging the non-cash collateral. Due from counterparties and Due to counterparties are carried at cost, which approximates fair value. To the extent the Company receives collateral other than cash from its counterparties such assets are not included in the Company's balance sheet. Notwithstanding the foregoing, if the Company either rehypothecates such assets or pledges the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability is reflected on the balance sheet.

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*Derivatives and hedging activities*

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

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

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

The Company also invests in Agency Interest-Only Strips, Agency Inverse Interest-Only Strips, swaptions and TBAs. The Company evaluates the terms and conditions of its holdings of Agency Interest-Only Strips, Agency Inverse Interest-Only Strips, swaptions and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. Accordingly, Agency Interest-Only Strips, Agency Inverse Interest-Only Strips, swaptions and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in its Statement of Operations, along with any interest earned (including accrued amounts). The carrying value of these Agency Interest-Only Strips, Agency Inverse Interest-Only Strips, swaptions and TBAs is included in Residential mortgage-backed securities on the Balance Sheet.

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. See Warrants below. Derivative instruments are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned (including accrued amounts) reported in the Gain (loss) on derivatives, net in the Statements of Operations.

*Repurchase agreements*

Mortgage-backed securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on the Company's Balance Sheet as an asset and cash received from the lender is recorded in the Company's Balance Sheet as a liability, unless they are accounted for as linked transactions, described below. Interest paid in accordance with repurchase agreements is recorded as interest expense, unless they are accounted for as linked transactions, described below. The Company reflects all proceeds from repurchase agreement borrowings and repayment of repurchase agreement borrowings which

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are not linked transactions, including transactions pertaining to collateral received with respect with certain swap transactions, on a gross basis on the Statement of Cash Flows.

### *Linked Transactions*

In instances where the Company finances securities through repurchase agreements with the same counterparty from which the securities were purchased, the Company accounts for the purchase commitment and repurchase agreement on a net basis and records a forward commitment to purchase securities as a derivative instrument if the transaction does not comply with the criteria for gross presentation. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in Gain on linked transactions, net on its Statement of Operations. If the transaction complies with the criteria for gross presentation, the Company records the assets and the related financing on a gross basis in its Balance Sheet and the corresponding interest income and interest expense in its Statement of Operations.

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*Share-based compensation*

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

*Warrants*

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the statements of operations. Financial instruments without the features of liabilities are recorded as a component of equity. For the Company's warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company's common stock in the private placement to certain accredited institutional investors on May 15, 2012, were evaluated by the Company and were recorded at their relative fair value as a component of equity at the date of issuance.

*Income taxes*

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

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

The Company may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries ( TRS ). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes, and its value may not exceed 25% of the value of the Company. While a TRS will generate net income, a TRS can declare dividends to the Company, which will be included in the Company's



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taxable income and necessitate a distribution to its stockholders. Conversely, if the Company retains earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity. As of June 30, 2013, the Company did not have a TRS, or any other subsidiary.

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

### *Offering costs*

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

### *Earnings per share*

GAAP requires use of the two-class method of computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity.

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

***Comprehensive Income (Loss)***

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

***Accounting standards applicable to emerging growth companies***

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

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

***Recent accounting pronouncements***

***Accounting Standards Adopted in 2013***

In December 2011, the FASB issued guidance requiring additional disclosure information about offsetting and related arrangements. Further in December 2012, the FASB proposed an update intended to address implementation of the December 2011 guidance. In January 2013, the FASB issued guidance to limit the scope of the new balance sheet and offsetting disclosure requirements of prior guidance related to certain derivatives (including bifurcated embedded derivatives,) repurchase agreements and reverse repurchase agreements, and securities borrowing

and securities lending transactions. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements and securities lending arrangements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards. The guidance is effective for periods beginning on or after January 1, 2013 and interim periods within those annual periods. While this guidance did result in certain additional disclosures, it did not have a material impact on the Company's financial statements.

**Note 4 Fair Value of Financial Instruments**

*Fair Value Accounting Elections*

The Company has elected the fair value option for all of its RMBS, and as a result, all changes in the fair value of such securities are reflected in the results of operations.

Table of Contents**Financial Instruments carried at Fair Value**

The following tables present the Company's financial instruments, carried at fair value as of June 30, 2013 and December 31, 2012, based upon the valuation hierarchy (dollars in thousands):

	June 30, 2013			
	Level I	Level II	Level III	Total
<b>Assets</b>				
Agency RMBS	\$	\$ 3,913,602	\$	\$ 3,913,602
Agency Interest-Only Strips accounted for as derivatives, included in RMBS		99,574		99,574
Non-Agency RMBS		173,574		173,574
Subtotal		4,186,750		4,186,750
Derivative assets		118,332		118,332
Non-Agency linked transactions		1,647		1,647
Total	\$	\$ 4,306,729	\$	\$ 4,306,729
<b>Liabilities</b>				
Derivative liabilities	\$	\$ 1,484	\$	\$ 1,484
Total	\$	\$ 1,484	\$	\$ 1,484

	December 31, 2012			
	Level I	Level II	Level III	Total
<b>Assets</b>				
Agency RMBS	\$	\$ 5,118,121	\$	\$ 5,118,121
Agency Interest-Only Strips accounted for as derivatives, included in RMBS		75,387		75,387
Non-Agency RMBS		19,073		19,073
Subtotal		5,212,581		5,212,581
Derivative assets		24,344		24,344
Total	\$	\$ 5,236,925	\$	\$ 5,236,925
<b>Liabilities</b>				
Derivative liabilities	\$	\$ 4,771	\$	\$ 4,771
Total	\$	\$ 4,771	\$	\$ 4,771

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

The Company generally receives one independent pricing service price for each investment in its portfolio. The Manager has established a process to review and validate the pricing received from the independent pricing service and has a process for challenging prices received from the independent pricing service when necessary. The Company utilizes its Manager's policies in this regard. The Company's and the Manager's review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. The Manager's pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to

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alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager's pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price.

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To ensure proper fair value hierarchy, the Company and the Manager review the methodology used by the third party pricing service to understand whether observable or unobservable inputs are being utilized in the vendor's evaluation methodology. Generally, this review is conducted annually, however ad-hoc reviews of the evaluation methodology and the assumptive data does occur. The review of the assumptive data received from the vendor includes comparing key inputs such as weighted average life, spread, prepayment assumptions to data obtained from other third-party data providers or internal valuation models. In addition, as part of the Company's regular review of pricing, the Manager's pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the inputs into their method.

**Other Fair Value Disclosures**

Cash and cash equivalents as well as Due from counterparties and Due to counterparties on the Company's Balance Sheets are reflected at cost which approximates fair value.

The fair value of the repurchase agreements is a Level II fair value measurement, based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best estimate current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies can have a material effect on the fair value amounts. At June 30, 2013, the Company's borrowings under repurchase agreements had a fair value of approximately \$4.0 billion and a carrying value of approximately \$4.0 billion.

**Note 5 Residential Mortgage-Backed Securities**

The following table presents certain information about the Company's investment portfolio at June 30, 2013 and December 31, 2012 (dollars in thousands). Real estate securities that are accounted for as a component of linked transactions are not reflected in the tables set forth in this note. See Note 8 for further details.

	June 30, 2013						
	Principal Balance	Unamortized Premium (Discount), net	Non-Accretable Discount	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year Mortgage	\$ 772,204	\$ 43,489	\$	\$ 815,693	\$ (29,800)	\$ 785,893	3.1%
30-Year Mortgage	2,846,261	249,360		3,095,621	(170,926)	2,924,695	3.7%
Agency Interest Only- Strips	N/A	N/A		199,132	3,882	203,014	4.3%(2)
Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A		N/A	N/A	99,574	5.0%(2)
Non-Agency RMBS	272,681	(30,762)	(68,071)	173,848	(274)	173,574	1.0%
Total	\$ 3,891,146	\$ 262,087	\$ (68,071)	\$ 4,284,294	\$ (197,118)	\$ 4,186,750	3.7%

December 31, 2012

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	Principal Balance	Unamortized Premium (Discount), net	Non-Accrutable Discount	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year Mortgage	\$ 299,251	\$ 20,460	\$	\$ 319,711	\$ (827)	\$ 318,884	3.2%
30-Year Mortgage	4,180,104	352,378		4,532,482	17,489	4,549,971	3.7%
CMO Fixed rate	66,000	9,776		75,776	(1,546)	74,230	6.5%
Agency Interest Only- Strips	N/A	N/A		176,093	(1,057)	175,036	4.5%(2)
Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A		N/A	N/A	75,387	4.9%(2)
Non-Agency RMBS	37,372	(5,511)	(12,659)	19,202	(129)	19,073	0.5%
Total	\$ 4,582,727	\$ 377,103	\$ (12,659)	\$ 5,123,264	\$ 13,930	\$ 5,212,581	3.9%

(1) Net weighted average coupon as of June 30, 2013 and December 31, 2012 is presented, net of servicing and other fees.

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

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

As of June 30, 2013 the weighted average expected remaining term to maturity of the investment portfolio is 9.1 years.

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

	June 30,	
	2013	December 31, 2012
Principal balance	\$ 3,891,146	\$ 4,582,727
Amortized cost of IOs and IIOs	199,132	176,093
Carrying value of Agency Interest-Only Strips accounted for as derivatives	99,574	75,387
Unamortized premium	292,849	382,614
Unamortized discount	(30,762)	(5,511)
Non-Accretable discount	(68,071)	(12,659)
Gross unrealized gains	11,987	25,395
Gross unrealized losses	(209,105)	(11,465)
Fair value	\$ 4,186,750	\$ 5,212,581

As of June 30, 2013, the Company held Agency RMBS with a fair value of approximately \$3.8 billion in an unrealized loss position of approximately \$205.7 million. As of June 30, 2013, the Company held Non-Agency RMBS with a fair value of approximately \$99.4 million in an unrealized loss position of approximately \$3.4 million. As of June 30, 2013, the Company held no investments in an unrealized loss position for greater than one year. At June 30, 2013, the Company did not intend to sell any of its Agency RMBS that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these RMBS before recovery of their amortized cost basis, which may be at their maturity.

The Company assesses its Agency RMBS and Non-Agency RMBS rated AA and higher at the time of purchase for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other than temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent that it is more likely than not that the Company can hold the security until recovery of its cost basis. The Company's prepayment speed estimate is the primary assumption used to determine other-than-temporary impairments for Agency IOs and IIOs, including Agency IOs and IIOs accounted for as derivatives, for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012. The Company recorded other than temporary impairments for the three and six months ended June 30, 2013 of approximately \$3.5 million and \$5.8 million, respectively and \$87 thousand for the period from May 15, 2012 (commencement of operations) through June 30, 2012 for Agency IOs, Agency IIOs and 20-year Agency RMBS which is reported as Other loss on Residential mortgage-backed securities in the Company's Statement of Operations.

For Non-Agency RMBS that are purchased at a discount to par value and are rated below AA at the time of purchase and Agency Interest-Only Strips that are not classified as derivatives, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. These adjustments are reflected in the Company's Statement of Operations as Other loss on Residential mortgage-backed securities. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. If an other-than-temporary impairment is recognized as a result of this analysis, the yield is maintained at the current accretion rate. The last revised estimated cash flows are then used for future impairment analysis purposes. The Company recorded no other than temporary impairments for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012 for Non-Agency RMBS.





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

For the three months ended June 30, 2013				
		Net (Premium Amortization/ Amortization Basis)		
	Coupon Interest	Discount Amortization	Interest Income	
Agency RMBS	\$ 45,788	\$ (15,380)	\$ 30,408	
Non-Agency RMBS	623	1,711	2,334	
Total	\$ 46,411	\$ (13,669)	\$ 32,742	

For the six months ended June 30, 2013				
		Net (Premium Amortization/ Amortization Basis)		
	Coupon Interest	Discount Amortization	Interest Income	
Agency RMBS	\$ 96,307	\$ (33,729)	\$ 62,578	
Non-Agency RMBS	1,105	2,809	3,914	
Total	\$ 97,412	\$ (30,920)	\$ 66,492	

For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)				
		Net (Premium Amortization/ Amortization Basis)		
	Coupon Interest	Discount Amortization	Interest Income	
Agency RMBS	\$ 8,912	\$ (1,829)	\$ 7,083	
Total	\$ 8,912	\$ (1,829)	\$ 7,083	

The following tables present the sales of the Company's RMBS (dollars in thousands).

For the three months ended June 30, 2013				
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS	\$ 317,170	\$	\$ (10,462)	\$ (10,462)
Non-Agency RMBS	67,184	4,379		4,379
Total	\$ 384,354	\$ 4,379	\$ (10,462)	\$ (6,083)

For the six months ended June 30, 2013				
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	\$ 2,145,888	\$ 8,646	\$ (30,867)	\$ (22,221)
Non-Agency RMBS	67,184	4,379		4,379
Total	\$ 2,213,072	\$ 13,025	\$ (30,867)	\$ (17,842)

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

	<b>For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)</b>				
	<b>Proceeds</b>	<b>Gross Gains</b>	<b>Gross Losses</b>	<b>Net Gain (Loss)</b>	
Agency RMBS	\$ 238,872	\$ 983	\$ (25)	\$ 958	
Other Securities	100,854	199		199	
Total	\$ 339,726	\$ 1,182	\$ (25)	\$ 1,157	

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**Note 6 Borrowings under Repurchase Agreements**

As of June 30, 2013, the Company had master repurchase agreements with 17 counterparties. As of June 30, 2013, the Company had borrowings under repurchase agreements with 15 counterparties. For the three and six months ended June 30, 2013, the Company had average borrowings under its repurchase agreements of approximately \$4.0 billion and \$4.3 billion, respectively, had a maximum month-end balance during the three and six months ended of approximately \$4.2 billion and \$4.8 billion, respectively and accrued interest payable of approximately \$1.5 million. For the period from May 15, 2012 (commencement of operations) through June 30, 2012, the Company had average borrowings under its repurchase agreements of approximately \$1.5 billion and had a maximum month-end balance during the period of approximately \$1.7 billion and accrued interest payable of approximately \$279 thousand.

The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company's repurchase agreement borrowings are accounted for as secured borrowings when the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. The inability of the Company to post adequate collateral for a margin call by the counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under the Company's repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have an adverse effect on the Company's financial condition and results of operations. The recent volatility and spread widening in both the Agency and Non-Agency RMBS markets during the three months ended June 30, 2013, necessitated the Company being required to post additional collateral with respect to its repurchase agreements. The Company was able to satisfy the requirement for incremental collateral by utilizing unpledged assets and cash on hand. In addition, the Company also pledged U.S. Treasury securities it received from its interest rate swap counterparties as incremental collateral in order to generate additional cash proceeds in order to satisfy such margin requirements. Continued volatility in these markets may create additional stress on the overall liquidity of the Company due to the long-term nature of its assets and the short-term nature of its liabilities. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, the Company could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on the Company's financial position, results of operations and cash flows. All of the Company's repurchase agreement counterparties are either U.S. financial institutions or the U.S. broker-dealer subsidiaries of foreign financial institutions.

Further, if the Company is unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms it may have an adverse effect on the Company's business and results of operations, due to the long term nature of the Company's investments and relatively short-term maturities of the Company's repurchase agreements. The financial covenants of certain of the repurchase agreements require the Company to maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of the Company's portfolio. The Company is in compliance with these covenants for the three and six months ended and at June 30, 2013.

The following tables summarize certain characteristics of the Company's repurchase agreements at June 30, 2013 and December 31, 2012 (dollars in thousands):

RMBS Pledged	Repurchase Agreement Borrowings	June 30, 2013 Weighted Average Interest Rate on Borrowings Outstanding at end	Weighted Average Remaining Maturity (days)
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			of period	
Agency RMBS	\$	3,864,990	0.40%	31
Non-Agency RMBS		96,639	1.79%	22
Total	\$	3,961,629	0.44%	31

RMBS Pledged	Repurchase Agreement Borrowings	December 31, 2012 Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)
Agency RMBS	\$ 4,794,730	0.48%	19
Total	\$ 4,794,730	0.48%	19

At June 30, 2013, repurchase agreements collateralized by RMBS had the following remaining maturities.

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(dollars in thousands)	Balance
Overnight	\$ 66,083
2 to 29 days	2,108,710
30 to 59 days	1,401,570
60 to 89 days	385,266
90 to 119 days	
Greater than or equal to 120 days	
Total	\$ 3,961,629

As discussed in Note 3, for any transactions determined to be linked, the initial transfer and repurchase financing will be recorded as a forward commitment to purchase assets. At June 30, 2013, the Company had repurchase agreements of approximately \$3.3 million that were accounted for as linked transactions. At December 31, 2012, the Company had no transactions determined to be linked. These linked repurchase agreements are not included in the above tables. See Note 8 for details.

At June 30, 2013, the following table reflects amounts at risk under its repurchase agreements greater than 10% of the Company's equity with any counterparty, including linked transactions.

Counterparty	June 30, 2013 (dollars in thousands)		
	Amount at Risk, at fair value	Weighted Average Remaining Maturity (days)	Percentage of Stockholders Equity
JP Morgan Securities LLC	\$ 60,869	14	14.2%
Credit Suisse Securities (USA) LLC	54,903	13	13.0
Barclays Capital Inc.	43,573	38	10.3

**Note 7 Collateral Positions**

The following tables summarize the Company's collateral positions, with respect to its borrowings under repurchase agreements, derivatives and clearing margin account at June 30, 2013 and December 31, 2012 (dollars in thousands):

	June 30, 2013		
	Assets Pledged- Fair Value	Accrued Interest	Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	\$ 4,001,774	\$ 14,957	\$ 4,016,731
Non-Agency RMBS	144,872	111	144,983
Cash (1)	123,232		123,232
Cash collateral for derivatives (1):	11,177		11,177
Total	\$ 4,281,055	\$ 15,068	\$ 4,296,123

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	December 31, 2012		
	Assets Pledged - Fair Value	Accrued Interest, as Revised(2)	Fair Value of Assets Pledged and Accrued Interest, as Revised(2)
Assets pledged for borrowings under repurchase agreements:			
Agency RMBS	\$ 5,043,824	\$ 15,552	\$ 5,059,376
Cash (1)	35,982		35,982
Cash collateral for derivatives (1):	18,160		18,160
Total	\$ 5,097,966	\$ 15,552	\$ 5,113,518

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

(2) The accrued interest related to Agency RMBS was incorrectly disclosed as \$67,551 in prior disclosure, and has been revised above.

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A reduction in the value of pledged assets typically results in the repurchase agreement counterparties, derivative counterparties and clearing margin counterparties initiating a daily margin call. At June 30, 2013 and December 31, 2012, RMBS held by counterparties as security for repurchase agreements totaled approximately \$4.1 billion and \$5.0 billion, respectively. The collateral held by each of the counterparties was in excess of 5% of the Company stockholders' equity. Cash collateral held by counterparties at June 30, 2013 and December 31, 2012 was approximately \$134.4 and \$54.1 million, respectively. At June 30, 2013, March 31, 2013, December 31, 2012, and June 30, 2012, the Company held incremental collateral of approximately \$94.4 million, \$5.1 million, \$0 and \$0 received from its interest rate swap and swaption counterparties as security for such agreements, respectively. In addition, at June 30, 2013, March 31, 2013, December 31, 2012, and June 30, 2012, the Company held securities of approximately \$1.5 million, \$3.7 million, \$2.6 million and \$5.6 million, respectively, received as collateral from its repurchase agreement counterparties to satisfy margin requirements.

At June 30, 2013, the approximately \$94.4 million of incremental collateral posted by its swap counterparties consisted of U.S. Treasury securities, of which \$39.8 million was posted as collateral for borrowings under repurchase agreements, reflected as Due to counterparties on the Company's Balance Sheet.

**Note 8 Derivative Instruments**

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

***Interest rate swaps and interest rate swaptions***

The Company is exposed to certain risk arising from both its business operations and economic conditions. Specifically, the Company's primary source of debt funding is repurchase agreements and the Company enters into derivative financial instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as the London interbank offered rate or LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates, the Company enters into interest rate swap agreements which help to mitigate the volatility in the interest rate exposures and their related cash flows. Interest rate swaps involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the interest rate swap without exchange of the underlying notional amount.

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

The Company's interest rate swaps, interest rate swaptions, TBA derivative instruments, linked transactions and options consisted of the following at June 30, 2013 and December 31, 2012 (dollars in thousands):



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Derivative Instrument	Designation	Balance Sheet Location	Notional Amount	June 30, 2013	
				Fair Value, excluding accrued interest	Accrued Interest Payable
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	\$ 2,301,050	\$ 80,709	\$ 4,411
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	1,214,000	37,589	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	50,000	34	
Total derivative instruments, assets			3,565,050	118,332	4,411
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	550,000	(1,484)	
Total derivative instruments, liabilities			550,000	(1,484)	
Linked transactions (1)	Non-Hedge	Linked transactions, net, at fair value	8,153	1,647	
Total derivative instruments			\$ 4,123,203	\$ 118,495	\$ 4,411

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

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Derivative Instrument	Designation	Balance Sheet Location	Notional Amount	December 31, 2012	
				Fair Value, excluding accrued interest	Accrued Interest Payable
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	\$ 1,827,300	\$ 11,201	\$ 2,519
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	520,000	10,087	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	425,000	3,056	
Total derivative instruments, assets			2,772,300	24,344	2,519
Interest rate swaps, liabilities	Non-Hedge	Derivative liability, at fair value	984,500	(3,552)	588
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	425,000	(1,219)	
Total derivative instruments, liabilities			1,409,500	(4,771)	588
Total derivative instruments			\$ 4,181,800	\$ 19,573	\$ 3,107

The following tables summarize the average fixed pay rate and average maturity for the Company's interest rate swaps as of June 30, 2013 and December 31, 2012 (excludes interest rate swaptions) (dollars in thousands):

Remaining Interest Rate	interest rate swap Term	Notional Amount	June 30, 2013		
			Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 1 year and less than 3 years		\$ 556,100	0.4%	1.7	26.8%
Greater than 3 years and less than 5 years		411,400	0.9	4.6	
Greater than 5 years		1,333,550	1.9	10.2	30.1
Total		\$ 2,301,050	1.4%	7.1	23.9%

Remaining Interest Rate	interest rate swap Term	Notional Amount	December 31, 2012		
			Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 1 year and less than 3 years		\$ 762,800	0.4%	2.3	22.7%
Greater than 3 years and less than 5 years		439,500	0.8	4.8	10.2
Greater than 5 years		1,609,500	1.7	10.2	30.1
Total		\$ 2,811,800	1.2%	7.2	25.0%

The Company's agreements with certain of its interest rate swap counterparties may be terminated at the option of the counterparty if the Company does not maintain certain equity and leverage metrics, the most restrictive of which contain provisions which become more restrictive based upon portfolio composition. Through June 30, 2013, the Company was in compliance with the terms of such financial tests.

At June 30, 2013, the Company held four swaptions with notional amounts of \$75.0 million, \$222.5 million, \$750.0 million and \$166.5 million, respectively that expire in one month, three months, five months and thirty-five months, respectively. If exercised, the Company can enter into a 10 year fixed pay swap agreement, a 20 year fixed pay swap agreement, a 10 year fixed pay swap agreement and a 7 year fixed pay swap agreement, respectively at a predetermined strike price.

The Company has minimum collateral posting thresholds with certain of its derivative counterparties, for which it typically pledges cash. As of June 30, 2013 and December 31, 2012, the Company had cash pledged as collateral of approximately \$11.2 million and \$18.2 million, respectively, which is reported on the Balance Sheets as Due from counterparties. As of June 30, 2013, the Company has swaps with two counterparties that are based in England and Switzerland with fair values in an asset position of approximately \$18.8 million and \$29.3 million and notional balances of \$416.9 million and \$1.0 billion, respectively.

*Agency Interest-Only Strips*

The Company also invests in Agency Interest-Only Strips. The Company has evaluated the terms and conditions of its holdings of Agency Interest-Only Strips to determine if these instruments have the characteristics of investments or would be considered derivatives under GAAP. Accordingly, Agency Interest-Only Strips having the characteristics of derivatives have been accounted for at fair value with changes recognized in Gain (loss) on derivative instruments, net in the Statement of Operations, along with any interest received. The carrying value of these Agency Interest-Only Strips is included in Residential mortgage-backed securities on the Balance Sheet.

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*To-be-announced securities*

The Company also purchased or shorted TBAs. As of June 30, 2013 and December 31, 2012, the Company had contracts to purchase ( long position ) and sell ( short position ) TBAs on a forward basis. Following is a summary of the Company's long and short TBA positions reported in Derivative assets, at fair value on the Balance Sheets as of June 30, 2013 and December 31, 2012 (dollars in thousands):

	June 30, 2013		December 31, 2012	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Purchase contracts, asset	\$ 50,000	\$ 34	\$ 425,000	\$ 3,056
Sale contracts, asset				
TBA securities, asset	50,000	34	425,000	3,056
Purchase contracts, liability	50,000	(90)		
Sale contracts, liability	(600,000)	(1,394)	(425,000)	(1,219)
TBA securities, liability	(550,000)	(1,484)	(425,000)	(1,219)
TBA securities, net	\$ (500,000)	\$ (1,450)	\$	\$ 1,837

	Notional Amount as of December 31, 2012	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of June 30, 2013
Purchase of TBAs	\$ 425,000	1,649,000	\$ (1,974,000)	\$ 100,000
Sale of TBAs	\$ 425,000	2,225,000	\$ (2,050,000)	\$ 600,000

The following table summarizes the effect of interest rate swaps, swaptions, options, Agency Interest-Only Strips as derivatives and TBAs reported in Gain (loss) on derivative instruments, net on the Company's Statement of Operations for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012 (dollars in thousands):

Description	Three months ended June 30, 2013				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to-market adjustments	Total
Interest rate swaps	\$ 23,881	\$ (5,156)	\$	\$ 71,202	\$ 89,927
Interest rate swaptions	1,038			20,751	21,789
Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted for as derivatives		7,032	(4,631)	3,633	6,034
Options	(925)			324	(601)
TBAs	(3,164)			(4,511)	(7,675)
Total	\$ 20,830	\$ 1,876	\$ (4,631)	\$ 91,399	\$ 109,474

Six months ended June 30, 2013

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Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to- market adjustments	Total
Interest rate swaps	\$ 42,139	\$ (9,738)	\$	\$ 73,060	\$ 105,461
Interest rate swaptions	1,038			19,245	20,283
Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted for as derivatives	(99)	12,975	(8,816)	1,285	5,345
Options	(925)				(925)
TBAs	(2,563)			(3,287)	(5,850)
Total	\$ 39,590	\$ 3,237	\$ (8,816)	\$ 90,303	\$ 124,314

For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)

Description	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to- market adjustments	Total
Interest rate swaps	\$ 4	\$ (726)	\$	\$ (5,044)	\$ (5,766)
Interest rate swaptions					
Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted for as derivatives		954	(122)	(225)	607
Options					
TBAs					
Total	\$ 4	\$ 228	\$ (122)	\$ (5,269)	\$ (5,159)

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

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*Linked Transactions*

As discussed in Note 3, when the initial transfer of a financial asset and repurchase financing are entered into contemporaneously with, or in contemplation of, one another, the transaction will be considered linked unless all of the criteria found in the applicable accounting guidance are met at the inception of the transaction. If the transaction is determined to be linked, the Company records the initial transfer and repurchase financing on a net basis and records a forward commitment to purchase assets as a derivative instrument with changes in market value being recorded on the Statement of Operations. While linked transactions are treated as derivatives for GAAP, the fair value of linked transactions reflects the value of the underlying security's fair market value netted with the respective linked repurchase agreement borrowings. The Company had no linked transactions at December 31, 2012.

The following table presents certain information related to the securities and repurchase agreements accounted for as part of linked transaction which is reported in Linked transactions, net, at fair value on the Balance Sheet and in Gain on linked transactions, net on the Statement of Operations for the three and six months ended June 30, 2013 (dollars in thousands):

Instrument	For the Three Months Ended June 30, 2013								Weighted Average Life (years)/ Weighted Average days to Maturity(2)
	Current Face(2)	Amortized Cost(2)	Fair Value(2)	Net Interest Income(1) (Expense)	Mark-to-market adjustments on linked transactions	Net Realized Gain	Gain on linked transactions, net	Weighted Average Coupon / Cost of Funds(2)	
Agency RMBS	\$	\$	\$	\$ 44	\$	\$ (254)	\$ (210)	n/a	n/a
Non-Agency RMBS	8,153	4,908	4,933	518	(296)	4,002	4,224	0.35%	8.4 years
Agency Repurchase Agreement				(6)			(6)	n/a	n/a
Non-Agency Repurchase Agreement	(3,286)	(3,286)	(3,286)	(99)			(99)	1.70%	26 days
Linked transactions, net, at fair value	\$ 4,867	\$ 1,622	\$ 1,647	\$ 457	\$ (296)	\$ 3,748	\$ 3,909	n/a	n/a

(1) Net interest income includes amortization of premium of \$9 thousand for Agency RMBS and accretion of discount of \$437 thousand for Non-Agency RMBS.

(2) Includes information only for linked transactions at June 30, 2013.

Instrument	For the Six Months Ended June 30, 2013								Weighted Average Life (years)/ Weighted Average days to Maturity(2)
	Current Face(2)	Amortized Cost(2)	Fair Value(2)	Net Interest Income(1) (Expense)	Mark-to-market adjustments on linked transactions	Net Realized Gain	Gain on linked transactions, net	Weighted Average Coupon / Cost of Funds(2)	
Agency RMBS	\$	\$	\$	\$ 44	\$	\$ (254)	\$ (210)	n/a	n/a
Non-Agency RMBS	8,153	4,908	4,933	953	(46)	4,002	4,909	0.35%	8.4 years
Agency Repurchase				(6)			(6)	n/a	n/a

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Agreement											
Non-Agency											
Repurchase											
Agreement	(3,286)	(3,286)	(3,286)	(188)			(188)		1.70%		26 days
Linked											
transactions, net,											
at fair value	\$ 4,867	\$ 1,622	\$ 1,647	\$ 803	\$ (46)	\$ 3,748	\$ 4,505		n/a		n/a

(1) Net interest income includes amortization of premium of \$9 thousand for Agency RMBS and accretion of discount of \$766 thousand for Non-Agency RMBS.

(2) Includes information only for linked transactions at June 30, 2013.

The Company had posted cash of approximately \$11.2 million and \$18.2 million pledged as collateral against its derivatives at June 30, 2013 and December 31, 2012, respectively. At June 30, 2013, the Company held U.S. Treasury securities of approximately \$94.4 million as posted collateral by its swap counterparties, of which \$39.8 million was posted as collateral for borrowings under repurchase agreements, reflected as Due to counterparties on the Company's Balance Sheet and approximately \$1.5 million in cash was posted with one of the Company's repurchase agreement counterparties to satisfy a margin call. The Company also pledged assets accounted for within linked transactions with a fair value of approximately \$4.9 million as collateral against the related linked repurchase agreements. The Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events.

Table of Contents**Note 9 Offsetting Assets and Liabilities**

The following tables present information about certain assets and liabilities that are subject to master netting agreements (or similar agreements) and can potentially be offset on the Company's balance sheets at June 30, 2013 and December 31, 2012:

**Offsetting of Derivative Assets****As of June 30, 2013**

\$s in thousands Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet Financial Instruments (1)	Cash Collateral Received	Net Amount
Agency Interest-Only Strips, accounted for as derivatives included in RMBS	\$ 99,574	\$	\$ 99,574	\$ (91,999)	\$	\$ 7,575
Derivative asset, at fair value	118,332		118,332	(80,475)		37,857
Linked Transactions	4,933	(3,286)	1,647			1,647
<b>Total</b>	<b>\$ 222,839</b>	<b>\$ (3,286)</b>	<b>\$ 219,553</b>	<b>\$ (172,474)</b>	<b>\$</b>	<b>\$ 47,079</b>

**Offsetting of Derivative Liabilities and Repurchase agreements****As of June 30, 2013**

\$s in thousands Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Balance Sheet	Net Amounts of Liabilities presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet Financial Instruments (1)	Cash Collateral Pledged(1)	Net Amount
Derivative liability, at fair value(2)	\$ 1,484	\$	\$ 1,484	\$ (30)	\$	\$ 1,454
Due to counterparties(3)	39,000		39,000	(39,000)		
Repurchase Agreements(4)	3,961,629		3,961,629	(3,961,629)		
<b>Total</b>	<b>\$ 4,002,113</b>	<b>\$</b>	<b>\$ 4,002,113</b>	<b>\$ (4,000,659)</b>	<b>\$</b>	<b>\$ 1,454</b>

**Offsetting of Derivative Assets**



As of December 31, 2012

\$s in thousands Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		Net Amount
				Financial Instruments (1)	Cash Collateral Received	
Agency Interest-Only Strips, accounted for as derivatives included in RMBS	\$ 75,387	\$	\$ 75,387	\$ (46,686)	\$	\$ 28,701
Derivative asset, at fair value	24,344		24,344	(3,552)		20,792
<b>Total</b>	<b>\$ 99,731</b>	<b>\$</b>	<b>\$ 99,731</b>	<b>\$ (50,238)</b>	<b>\$</b>	<b>\$ 49,493</b>

Table of Contents**Offsetting of Derivative Liabilities and Repurchase agreements**

As of December 31, 2012

\$s in thousands Description	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Balance Sheet	Net Amounts of Liabilities presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		Net Amount
				Financial Instruments (1)	Cash Collateral Pledged(1)	
Derivative liability, at fair value(2)	\$ 4,771	\$	\$ 4,771	\$ (3,552)	\$	\$ 1,219
Repurchase Agreements(4)	4,794,730		4,794,730	(4,794,730)		
Total	\$ 4,799,501	\$	\$ 4,799,501	\$ (4,798,282)	\$	\$ 1,219

(1) Amounts disclosed in the Financial Instruments column of the table above represents collateral pledged that is available to be offset against liability balances associated with repurchase agreement and derivative transactions. In addition, amounts include U.S. Treasury securities posted with the Company by its swap counterparties. Amounts disclosed in the Cash Collateral Pledged column of the table above represents amounts pledged as collateral against derivative transactions.

(2) Cash collateral pledged against the Company's Swaps was approximately \$11.2 million and \$18.2 million at June 30, 2013 and December 31, 2012, respectively.

(3) The fair value of U.S. Treasury securities pledged against Due to counterparties was approximately \$39.8 million at June 30, 2013.

(4) The fair value of securities pledged against the Company's repurchase agreements was approximately \$4.2 billion and \$5.1 billion at June 30, 2013 and December 31, 2012, respectively.

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

**Note 10 Related Party Transactions****Management Agreement**

In connection with the Company's IPO in May 2012, the Company entered into a management agreement (the Management Agreement) with the Manager, which describes the services to be provided by the Manager and compensation for such services. The Manager is responsible for managing the Company's operations, including: (i) performing all of its day-to-day functions other than those provided by the Company's chief financial officer; (ii) determining investment criteria in conjunction with the board of directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management,

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subject to the direction and oversight of the Company's board of directors. Pursuant to the terms of the Management Agreement, the Manager is paid a management fee equal to 1.50% per annum of the Company's stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders' equity means the sum of the net proceeds from any issuances of the Company's equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of the Company's shares of common stock, excluding any unrealized gains, losses or other non-cash items, including OTTI charges included in other loss on RMBS, unrealized gain on RMBS and other securities and non-cash portion of Loss on derivative instruments, that have impacted stockholder's equity as reported in the Company's financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's independent directors and after approval by a majority of the Company's independent directors. However, if the Company's stockholders' equity for any given quarter is negative based on the calculation described above, the Manager will not be entitled to receive any management fee for that quarter.

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

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

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

For the three and six months ended June 30, 2013, the Company incurred approximately \$1.8 million and \$3.9 million in management fees, respectively. For the period from May 15, 2012 (commencement of operations) through June 30, 2012, the Company incurred approximately \$407 thousand in management fees. In addition to the management fee, the Company is also responsible for reimbursing the Manager for certain expenses paid by the Manager on behalf of the Company and for certain services provided by the Manager to the Company. For the three and six months ended June 30, the Company recorded expenses included in general and administrative expense totaling approximately \$45 thousand and \$54 thousand, respectively related to salary or employee benefits associated with the Company's sole employee paid by the Manager on behalf of the Company. For the period from May 15, 2012 (commencement of operations) through June 30, 2012, the Manager did not request reimbursement from the Company for any such expenses. Notwithstanding the foregoing, any such expenses incurred by the Manager and reimbursed by the Company are typically included in the Company's general and administrative expense on its Statement of Operations, or may be reflected on the Balance Sheet and associated statement of changes in stockholders' equity, based on the nature of the item. At June 30, 2013 and December 31, 2012, approximately \$2.0 million and \$1.9 million, respectively, for management fees incurred but not yet paid was included in payable to related party on the Balance Sheets.

**Note 11 Share-Based Payments**

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

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

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

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

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

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

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

The Equity Incentive Plans include provisions for grants of restricted common stock and other equity-based awards to the Manager, its employees and employees of its affiliates and to the Company's directors, officers and employees. The Company can issue up to 3.0% of the total number of issued and outstanding shares of its common stock (on a fully diluted basis) at the time of each award (other than any shares previously issued or subject to awards made pursuant to one of our Equity Incentive Plans) under these Equity Incentive Plans. At May 15, 2012, there were 308,335 shares of common stock initially reserved for issuance under the Equity Incentive Plans. Upon the completion of the October 3, 2012 follow-on common stock offering, the number of shares of common stock available for issuance under the Equity Incentive Plans increased to 722,335, inclusive of the 231,560 enumerated above. The Company recognized stock-based compensation expense of approximately \$251 thousand and \$537 thousand for the three and six months ended June 30, 2013, respectively, and \$54 thousand for the period from May 15, 2012 (commencement of operations) through June 30, 2012 and has unamortized compensation expense of approximately \$4.0 million and \$1.2 million at June 30, 2013 and December 31, 2012.

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

The following is a summary of restricted common stock vesting dates as of June 30, 2013 and December 31, 2012, including shares whose issuance has been deferred under the Director Deferred Fee Plan:

Vesting Date	June 30, 2013 Shares Vesting	December 31, 2012 Shares Vesting
January 2013		3,485
May 2013		21,553
January 2014	7,005	3,485
March 2014	50,000	
May 2014	17,053	17,053
June 2014	4,887	
January 2015	7,005	3,485
March 2015	50,000	
May 2015	17,053	17,053
January 2016	3,519	
March 2016	50,000	
	206,522	66,114

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The following table presents information with respect to the Company's restricted stock for the six month period ended June 30, 2013 including shares whose issuance has been deferred under the Director Deferred Fee Plan:

	<b>Shares of Restricted Stock</b>	<b>Weighted Average Grant Date Fair Value (1)</b>
Outstanding at beginning of period	66,114	\$ 19.86
Granted	165,446	\$ 21.22
Cancelled/forfeited		\$
Outstanding at June 30, 2013	231,560	\$ 20.84
Unvested at June 30, 2013	206,522	\$ 20.95

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

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**Note 12 Stockholders Equity**

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

Each of the aforementioned warrant units consists of one share of the Company's common stock and a warrant to purchase 0.5 of a share of the Company's common stock. At the time of issuance, each warrant had an exercise price of \$20.50 per share, subject to adjustment upon the occurrence of customary events triggering an anti-dilution adjustment and certain sales of the Company's common stock (see discussion below). In addition, the warrants are subject to certain limitations on exercise. The warrants expire on May 15, 2019. On October 3, 2012, as a result of the follow-on offering the exercise price of the warrants was reduced from \$20.50 to \$19.44.

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

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

On November 19, 2012, the Board of Directors of the Company approved the repurchase of up to 2.4 million shares of its common stock through December 31, 2013, either in the open market or through privately-negotiated transactions. The repurchase program is expected to be completed during 2013, and does not obligate the Company to acquire any particular amount of common stock. The Company made no share repurchases for the six months ended June 30, 2013.

**Note 13 Net Income per Common Share**

The table below presents basic and diluted net income per share of common stock for the three and six months ended June 30, 2013 and for the period from from May 15, 2012 (commencement of operations) through June 30, 2012, (dollars, other than shares and per share amounts, in thousands):



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	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013	For the period from May 15, 2012 (commencement of operations) through June 30, 2012
Numerator:			
Net income attributable to common stockholders and participating securities for basic and diluted earnings per share	\$ (27,654)	\$ (56,153)	\$ 4,261
Denominator:			
Weighted average common shares outstanding for basic earnings per share	24,305,631	24,256,175	10,334,824
Weighted average diluted shares outstanding (stock awards)			
Weighted average diluted shares outstanding (warrants)			
Weighted average common share outstanding for diluted earnings per share	24,305,631	24,256,175	10,334,824
Basic earnings per common share	\$ (1.14)	\$ (2.32)	\$ 0.41
Diluted earnings per common share	\$ (1.14)	\$ (2.32)	\$ 0.41

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The following potential common shares were excluded from diluted earnings per share for the three and six months ended June 30, 2013 as the Company had a net loss for the period: 12,207 and 11,832 related to stock awards, and 56,770 and 89,351 for outstanding warrants to purchase the Company's stock, respectively.

**Note 14 Income Taxes**

Based on the Company's analysis of any potential uncertain income tax positions, the Company concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria as of June 30, 2013. In the event that the Company incurs income tax related interest and penalties, the Company's policy is to classify them as a component of provision for income taxes.

**Note 15 Contingencies**

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any material contingencies as of June 30, 2013.

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

**FORWARD-LOOKING INFORMATION**

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

The forward-looking statements are based on the Company's beliefs, assumptions and expectations of its future performance, taking into account all information currently available to it. Forward-looking statements are not predictions of future events. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to the Company. Some of these factors are described in Item 1A - Risk Factors in the Company's annual report on Form 10-K for the year ended December 31, 2012, as filed on April 9, 2013 with the SEC. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that the Company files with the SEC, could cause its actual results to differ materially from those included in any forward-looking statements the Company makes. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect the Company. Except as required by law, the Company is not obligated to, and does not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with the Company's financial statements and the accompanying notes to the Company's financial statements, which are included in Item 1 of this Quarterly Report on Form 10-Q, as well as the information contained in the Company's annual report on Form 10-K for the year ended December 31, 2012, as filed on April 9, 2013 with the SEC.

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

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**Overview**

Western Asset Mortgage Capital Corporation (the **Company** unless otherwise indicated or except where the context otherwise requires **we**, **us** or **our**) is primarily focused on investing in, financing and managing Agency RMBS. While our core investment strategy is focused on Agency RMBS, we have opportunistically supplemented our portfolio with Non-Agency RMBS and may, in the future, opportunistically invest in commercial mortgage-backed securities (**CMBS**) and asset-backed securities (**ABS**), which we, collectively, refer to as our **Additional Target Assets**. We finance investments in Agency RMBS and our **Additional Target Assets** primarily through the use of repurchase agreements.

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

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

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

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

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

On October 3, 2012, as a result of the follow-on public offering of common stock the exercise price of each of the outstanding warrants was reduced from \$20.50 to \$19.44.

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We have invested the proceeds of our IPO, concurrent private placements and follow-on public offerings primarily in Agency RMBS, including Mortgage pass-through certificates, Agency derivatives, Agency Interest-Only Strips, Agency Inverse Interest-Only Strips, and Agency CMOs, as well as Non-Agency RMBS. We have also used to-be-announced forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we agree to purchase or deliver in the future Agency RMBS with certain principal and interest terms. At June 30, 2013, our portfolio was comprised of approximately \$4.0 billion of Agency RMBS and approximately \$173.6 million of Non-Agency RMBS, exclusive of linked transactions. In addition, at June 30, 2013, our linked transactions include approximately \$4.9 million of Non-Agency RMBS.

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

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As of June 30, 2013, we had entered into master repurchase agreements with 17 counterparties. As of June 30, 2013, we had approximately \$4.0 billion of borrowings, excluding borrowings on linked transactions, outstanding under our repurchase agreements collateralized by approximately \$4.1 billion of RMBS. In addition, at June 30, 2013, our linked transactions include approximately \$3.3 million of borrowings under repurchase agreements collateralized by approximately \$4.9 million of Non-Agency RMBS. In addition at June 30, 2013, March 31, 2013, December 31, 2012, and June 30, 2012, we held U.S. Treasury securities of approximately \$94.4 million, \$5.1 million, \$0 and \$0, respectively, as posted collateral by our swap counterparties. Of the approximately \$94.4 million of U.S. Treasury securities we held at June 30, 2013, approximately \$39.8 million was posted as collateral for borrowings under repurchase agreements of \$39.0 million, reflected as Due to counterparties on our Balance sheet and approximately \$1.5 million was posted with one of our repurchase agreement counterparties to satisfy a margin call. In addition, at June 30, 2013, March 31, 2013, December 31, 2012, and June 30, 2012, we held securities of approximately \$1.5 million, \$3.7 million, \$2.6 million, and \$5.6 million, respectively, received as collateral from our repurchase agreement counterparties to satisfy margin requirements.

We have entered into swaps to effectively fix (for the life of the swap) the floating interest rate of approximately \$2.3 billion of borrowings under our repurchase agreements. In addition, as of June 30, 2013, we also owned swaptions on approximately an incremental \$1.2 billion of borrowings. As of June 30, 2013, our aggregate Debt-to-equity ratio was approximately 9.4 to 1.

**Recent Market Conditions and Strategy**

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

The current economic and market outlook are shaped in a significant manner by the unprecedented level of fiscal and monetary stimulus that the U.S. Government and U.S. Federal Reserve Board provided in the aftermath of the 2008 credit crisis. The current rate environment is characterized by a steep yield curve with the spread between two-year U.S. Treasury Notes and ten-year U.S. Treasury Notes well above the average spread over the last three decades. The U.S. Federal Reserve Board has maintained a near-zero target for the federal funds rate, and has continually reiterated its commitment to do so in an effort to fulfilling its mandate to promote higher growth and lower unemployment and to maintain price stability in the U.S. economy.

In addition to maintaining its accommodative position with regard to the federal funds rate, the Federal Reserve Board has also implemented a number of strategies in an effort to apply increased downward pressure on longer-term interest rates in an effort to improve broader financial conditions. In September 2011, the Federal Reserve Board announced that it would purchase \$400 billion of Treasury securities with remaining maturities of six to thirty years and sell an equal amount of Treasury securities with remaining maturities of three years or less. This program, commonly referred to as Operation Twist was subsequently extended in June 2012 for the balance of 2012. In a press release issued on September 13, 2012, the Federal Reserve announced further market intervention, agreeing to purchase \$40 billion a month of Agency RMBS. This program generally referred to as QE3, was in addition to the Federal Reserve continuing to reinvest the \$45 billion of monthly principal payments it receives from its holdings of Agency debt and Agency RMBS in new Agency RMBS. The \$85 billion of combined monthly purchases by the Federal Reserve of Agency RMBS far exceeded monthly Agency RMBS origination at such time and continues to far exceed current originations. In December 2012, the Federal Reserve expanded QE3 to include the monthly purchase of \$45 billion of Treasury

Securities as well.

As recently as May 1, 2013, the Federal Reserve reaffirmed its intention to continue QE3 by announcing that it would maintain its current policy of reinvesting principal payments received on its Agency debt and RMBS in new Agency RMBS and purchase an additional \$40 billion of Agency RMBS and \$45 billion of Treasury securities a month. In the press release issued subsequent to its two day policy meeting, the Federal Reserve stated that it would continue its purchases of Agency RMBS and Treasury securities and that it was prepared to increase or reduce the pace of its purchases based on the outlook for the labor market and inflation. At the time of this announcement, the yield on the Ten-year U.S. Treasury reached its low for 2013 of 1.66%. Over the ensuing three weeks, the yield on the Ten-year U.S Treasury increased by 0.30% approaching 2.00%. In his May 22, 2013 testimony to Congress, Federal Reserve Chairman Ben Bernanke reiterated the intention of the Federal Reserve to maintain the federal funds rate between 0.00% and 0.25% as long as the unemployment rate remained above 6.5% and inflation remained below 2%. He added that the Federal Reserve would continue to evaluate the amount of Agency RMBS and Treasury securities that it would purchase based on the economic data received. During the question and answer session, Chairman Bernanke added that if the economy continued to improve, it was possible that the Federal Reserve could begin to reduce their purchases over the next few months.



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In the press release issued on June 19, 2013 at the conclusion of its two day policy meeting, the Federal Reserve acknowledged that while economic activity had expanded, unemployment remained high and inflation remained low. Accordingly, it would continue its accommodative monetary policy, maintaining the federal funds rate between 0.00% and 0.25% and its purchase of Agency RMBS and Treasury securities, but was evaluating economic data to determine if adjustments to the amount of its purchases were indicated. The market interpreted this statement as an announcement by the Federal Reserve that it was planning on reducing or tapering its purchases of Agency RMBS and Treasury securities in the coming months, causing the yield on the 10-year U.S. Treasury to rise above 2.50% and spreads on Agency RMBS widen substantially. As a result, the value of our twenty and thirty year fixed rate Agency RMBS portfolio was significantly reduced. In addition, we also incurred a reduction in the market value of our Non-Agency RMBS. While the reduction in market value of our Agency and Non-Agency RMBS were partially offset by an increase in the value of our interest swaps and swaptions, we did incur margin calls with respect to our repurchase agreements which required us to post additional collateral, securities and/or cash, with our counterparties.

Despite the market's anticipation of the near term commencement of tapering, the Federal Reserve at its July 30-31, 2013 meeting, elected to continue its purchasing of additional Agency RMBS and U.S. Treasury securities. The press release issued at the conclusion of the meeting stated the following:

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of \$40 billion per month and longer-term U.S. Treasury securities at a pace of \$45 billion per month. The committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and rolling over maturing U.S. Treasury securities at auction. Taken together, these actions should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

It is our Manager's view that while recent economic data suggests an improvement in U.S. economic growth, the significant mortgage debt burden, run-off of fiscal stimulus and budget discipline at both the U.S. federal and state level will serve as an impediment to real GDP and employment growth during the balance of 2013. Recent headline inflation data continues to be relatively modest. While there is a risk that interest rates do continue to increase, we do not believe core rates will increase meaningfully, largely due to a plentiful supply of labor, thereby effectively eliminating wage pressure, and low rates of resource utilization. For these reasons, and considering its dual mandate to manage both inflation and unemployment, we believe that the U.S. Federal Reserve Board will exercise patience before unwinding any form of monetary stimulus now in effect. We expect this type of muted recovery to keep the yield curve relatively steep and, barring any system shocks to the capital markets, provide attractive investment opportunities within the Agency and Non-Agency RMBS markets, especially at today's price levels.

Toward the end of 2012, our Manager established a small position of Non-Agency RMBS. Our Manager believes that Non-Agency RMBS can serve as a diversifying hedge in the event interest rates continue to rise. During the six months ended June 30, 2013, our Manager increased our position in Non-Agency RMBS and may continue to do so depending on the overall investment RMBS investment environment.

We believe investors continue to seek incremental spreads relative to U.S. Treasury Notes in a low yield environment and financial institutions continue to prefer high quality, liquid Agency RMBS. Yield spreads on Agency RMBS have increased and have become even more attractive relative to historical spread levels. As the capital markets have recovered, commercial banks have re-entered and continue to support the secured lending market, which has quickened the pace of asset recovery, and the return to more normalized credit spreads. Financing of Agency and Non-Agency RMBS is currently widely available through, among other vehicles, repurchase agreements. Haircuts, or the discount attributed to the value of securities sold under repurchase agreements, ranging from a low of 3.0% to a high of 5.5% for Agency RMBS, depending on the specific security used as collateral for such repurchase agreements, while haircuts for IOs and IIOs can be as high as 30% and haircuts for Non-Agency RMBS ranging from a low of 20% to a high of 45%. Even during the recent market volatility, such financing remained readily

available.

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

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On January 4, 2012, the U.S. Federal Reserve Board released a report titled *The U.S. Housing Market: Current Conditions and Policy Considerations* to Congress providing a framework for thinking about certain issues and tradeoffs that policy makers might consider. In a speech given in Phoenix, AZ on August 6, 2013, President Obama announced that he will propose to Congress that the role of the government in the U.S. mortgage market should be limited, thereby suggesting that private sector should effectively replace or eliminate the GSEs. It is unclear how future legislation may impact the housing finance market and the investing environment for agency securities as the method of reform is undecided and has not yet been defined by the regulators.

**Our Investment Strategy**

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

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

We currently purchase and sell Agency RMBS and have invested in a limited amount of Non-Agency RMBS. In the future, we may expand our purchase of Non-Agency RMBS as well as purchase and sell our other Additional Target Assets. Our Manager has not and does not expect to purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular security or our capital position.

**Our Target Assets**

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

*Agency RMBS* - Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as Government National Mortgage Association ( GNMA ), or a U.S. Government-sponsored entity, such as Federal National Mortgage Association ( FNMA ) or Federal Home Loan Mortgage Corporation ( FHLMC ). The Agency RMBS we acquire can be secured by fixed-rate

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mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on the amount by which the loan interest rate can change on any predetermined interest rate reset date. As of June 30, 2013, all of our Agency RMBS are secured by fixed-rate mortgages.

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

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*Agency Derivatives:*

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

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

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

CMOs involve Agency collateral and include Agency stripped securities, which are mortgage-backed securities structured with two or more classes that receive different distributions of principal or interest on a pool of Agency RMBS. Stripped securities include interest only Agency RMBS and inverse interest only Agency RMBS, each of which we may invest in subject to maintaining our qualification as a REIT.

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

**Our Additional Target Assets**

Although our primary investment strategy is focused on Agency RMBS, we have opportunistically supplemented our portfolio with Non-Agency RMBS and may do so with the other types of assets, which we define as part of our Additional Target Assets, described below.

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

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

*CMBS.* - Fixed and floating rate CMBS with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. We have not established a minimum current rating requirement.

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

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

As of June 30, 2013, the fair value of our investment portfolio was comprised of approximately 95.9% of Agency RMBS and 4.1% of Non-Agency RMBS, excluding linked transactions. As of June 30, 2013, the fair value of our investment portfolio was comprised of approximately 95.7% of Agency RMBS and 4.3% of Non-Agency RMBS, including linked transactions.

**Our Financing Strategy**

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

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

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

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

We expect to maintain a debt to equity ratio of seven to eleven times the amount of our stockholders' equity, although there is no minimum or maximum leverage that our investment policies explicitly require. Depending on the different cost of borrowing funds at different maturities, we will vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. We enter into collateralized borrowings only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. We rely on financing to acquire, on a leveraged basis, the Target Assets in which we invest. If market conditions deteriorate, our

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lenders may exit the repurchase market, and tighten lending standards, or increase the amount of equity capital required to obtain financing making it more difficult and costly for us to obtain financing.

For the three and six months ended June 30, 2013, we financed our RMBS with repurchase agreements, on a debt-to-equity basis, averaging approximately eight to ten times leverage throughout these periods. In the future, we may, however, be limited or restricted in the amount of leverage we may employ by the terms and provisions of any financing or other agreements, and may be subject to margin calls as a result of our financing activity. We had an aggregate debt-to-equity ratio, related to our repurchase agreements of approximately 9.4 to 1, excluding and including linked transactions, and 9.2 to 1 at June 30, 2013 and December 31, 2012, respectively.



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We initially financed our RMBS with repurchase agreement financing with maturities from one to three months, but in some cases longer. At June 30, 2013, we had entered into master repurchase agreements with 17 counterparties. We had approximately \$4.0 billion and \$4.8 billion outstanding under our repurchase agreements, including repurchase agreements accounted for as part of linked transactions at June 30, 2013 and December 31, 2012, respectively, but excluding repurchase agreements associated with U.S. Treasury securities posted with us by our interest rate swap and swaption counterparties. The balance outstanding at June 30, 2013 includes approximately \$3.3 million related to linked transactions.

**Our Hedging Strategy**

Subject to maintaining our qualification as a REIT for U.S. federal income purposes, we pursue various economic hedging strategies to seek to reduce our exposure to adverse changes in interest rates. The U.S. federal income tax rules applicable to REITs may require us to implement certain of these techniques through a domestic taxable REIT subsidiary ( TRS ) that is fully subject to federal corporate income taxation. At this time we do not utilize a domestic TRS, although we may consider doing so in future. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. As of June 30, 2013, we entered into swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps provide for fixed interest rates indexed off of the London interbank offered rate or LIBOR and effectively fix the floating interest rates on approximately \$2.3 billion of borrowings under our repurchase agreements. In addition, as of June 30, 2013, we also owned swaptions on approximately an incremental \$1.2 billion of borrowings. To date, we have not elected to apply hedge accounting for our derivatives and, as a result, we record the change in fair value of our derivatives and the associated interest in earnings.

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

**Revision of Previously Issued Financial Statements for Errors Affecting Certain Items Presented in the Statements of Operations and Statements of Cash Flows**

As previously reported in our annual report on Form 10-K for 2012, during the process of preparing our 2012 financial statements, we discovered that the methodology that was used to accrete interest income and to amortize the cost basis of certain of our residential mortgage backed securities, which was based on a third party vendor's system, as well as the presentation with regard to certain items in its Statement of Cash Flows were not in accordance with GAAP. We evaluated the impact of these errors and concluded that individually and in the aggregate, these errors were not material to any previously issued financial statements. However, we elected to revise the Statements of Operations for the period from May 15, 2012 (commencement of operations) through June 30, 2012 and the Statements of Cash Flows for the period from May 15, 2012 (commencement of operations) through June 30, 2012 in this quarterly financial statements on Form 10-Q to correct these errors. The corrections resulted in a reclassification of a portion of the our previously reported net interest income to realized and unrealized gains, and certain amounts previously reflected in operating cash flows to investing cash flows (as indicated in the tables below). These revisions had no effect on net income, shareholders' equity, net change in cash, or total assets, of the Company reported for this period. See Notes to Financial Statements - Note 2 for complete details.

**Critical Accounting Policies**

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

**Investments**

We elected the fair value option for all of our RMBS at the date of purchase, which permits us to measure these securities at fair value with the change in fair value included as a component of earnings.

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**Valuation of financial instruments**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

To ensure proper fair value hierarchy, we and our Manager review the methodology used by the third party pricing service to understand whether observable or unobservable inputs are being utilized in the vendor's evaluation methodology. Generally, this review is conducted annually, however ad-hoc reviews of the evaluation methodology and the assumptive data does occur. The review of the assumptive data received from the vendor includes comparing key inputs such as weighted average life, spread, prepayment assumptions to data obtained from other third-party data providers or internal valuation models. In addition, as part of our regular review of pricing, our Manager's pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the inputs into their method.

## **Linked transactions**

In instances where we acquire assets through repurchase agreements with the same counterparty from whom the assets were purchased, we will evaluate such transactions under GAAP. Under current guidance, the initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another will be considered linked unless all of the required criteria for gross or separate treatment are met at the inception of the transaction. If the transaction meets all of the conditions required for gross or separate treatment, the initial transfer will be accounted for separately from the repurchase financing, and we will record the asset and the related financing on a gross basis on our Balance Sheet with the corresponding interest income and interest expense in our statements of operations. If the transaction is determined to be linked, we will record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase asset as a derivative instrument with changes in market value being recorded on the Statement of Operations. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. The analysis of transactions under these rules requires assumptions based on management's judgment and experience.

## **Interest income recognition and Impairment**

*Agency RMBS and Non-Agency RMBS rated AA and higher at the time of purchase*

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

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A decline in the fair market value of our assets may require us to recognize an other-than-temporary impairment against such assets under GAAP if we were to determine that, with respect to any assets in unrealized loss positions, we do not have the intent to sell these investments, it is more likely than not that we will not be required to sell the investment before recovery of a security's amortized cost basis and we will not be required to sell the security for regulatory or other reasons. If such a determination is made, we would recognize unrealized losses through earnings and write down the amortized cost of such assets to a new cost basis, based on the fair value of such assets on the date they are considered to be other-than-temporarily impaired. Such impairment charges reflect non-cash losses at the time of recognition; subsequent disposition or sale of such assets can further affect our future losses or gains, as they are based on the difference between the sales price received and adjusted amortized cost of such assets at the time of sale.

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

*RMBS that are purchased at a discount to par value and are rated below AA at the time of purchase and Agency Interest-Only and Agency Inverse Interest-Only Strips that are not classified as derivatives*

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

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

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

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

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

Certain of the Company's Non-Agency RMBS that are purchased at a discount to par value and are rated below AA at the time of purchase and Agency Interest-Only and Agency Inverse Interest-Only Strips that are not classified as derivatives, that are in an unrealized loss position at June 30, 2013 are not considered other than temporarily impaired because the Company has no intent to sell these investments, it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis and the Company is not required to sell the security for regulatory or other reasons.



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**Derivatives and hedging activities**

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

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

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

We also invest in Agency Interest-Only Strips, Agency Inverse Interest-Only Strips and TBAs. We evaluate the terms and conditions of our holdings of Agency Interest-Only Strips, Agency Inverse Interest-Only Strips and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. Accordingly, Agency Interest-Only Strips, Agency Inverse Interest-Only Strips and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in our Statement of Operations, along with any interest earned (including accrued amounts). The carrying value of these Agency Interest-Only Strips, Agency Inverse Interest-Only Strips and TBAs is included in Residential mortgage-backed securities on the Balance Sheet.

We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. Our derivative instruments also include linked transactions, which reflect a forward commitment to purchase assets. Derivative instruments are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned (including accrued amounts) reported in Gain (loss) on derivative instruments, net in our Statement of Operations.

**Repurchase agreements**

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

In instances where we acquire securities through repurchase agreements with the same counterparty from which the securities were purchased, we will account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase securities as a derivative instrument if the transaction does not comply with the criteria for gross presentation. Such forward commitments will be recorded

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at fair value with subsequent changes in fair value recognized in income. Additionally, we will record the cash portion of our investment in securities as a mortgage-related receivable from the counterparty on our Balance Sheet. If the transaction complies with the criteria for gross presentation, we will record the assets and the related financing on a gross basis in our Balance Sheet and the corresponding interest income and interest expense in our Statements of Operations.

### **Share-based compensation**

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

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**Warrants**

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

**Income taxes**

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

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

We may elect to treat certain of our subsidiaries as TRSs. In general, a TRS of ours may hold assets and engage in activities that we cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes. While a TRS will generate net income, a TRS can declare dividends to us, which will be included in our taxable income and necessitate a distribution to our stockholders. Conversely, if we retain earnings at the TRS level, no distribution is required and we can increase book equity of the consolidated entity. As of June 30, 2013, we did not have a TRS, or any other subsidiary.

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

**Accounting standards applicable to emerging growth companies**

The JOBS Act contains provisions that relax certain requirements for emerging growth companies for which we qualify. For as long as we are an emerging growth company, which may be up to five full fiscal years, unlike other public companies, we will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies

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under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of our system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise. We may take advantage of any or all of such exemptions, but have not yet made a decision on whether to do so.

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

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**Recent accounting pronouncements**

*Accounting Standards Adopted in 2013*

In December 2011, the FASB issued guidance requiring additional disclosure information about offsetting and related arrangements. Further in December 2012, the FASB proposed an update intended to address implementation of the December 2011 guidance. In January 2013, the FASB issued guidance to limit the scope of the new balance sheet and offsetting disclosure requirements of prior guidance related to certain derivatives (including bifurcated embedded derivatives,) repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements and securities lending arrangements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards. The guidance is effective for periods beginning on or after January 1, 2013 and interim periods within those annual periods. While this guidance may result in certain additional disclosures, it did not have a material impact on our financial statements.

**Results of Operations**

The following discussion of our results of operations highlights our performance for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012.

**Investments**

The following table presents certain information about our RMBS investment portfolio at June 30, 2013, which is a Non-GAAP measure due to the inclusion of our Linked Transactions, in order to present a complete economic presentation of our RMBS portfolio, which is reconciled to GAAP below, as follows (dollars in thousands):

	Principal Balance	Unamortized Premium (Discount)	Non-Accrutable Discount	Amortized Cost	Unrealized Gain (Loss)	Estimated Fair Value	Net Weighted Average Coupon(1)
Agency RMBS							
20-Year Mortgage							
Coupon Rate:							
3.00%	\$ 629,104	\$ 32,338	\$	661,442	\$ (24,442)	\$ 637,000	3.0%
3.50%	103,509	6,842		110,351	(3,373)	106,978	3.5%
4.00%	39,591	4,309		43,900	(1,985)	41,915	4.0%
	772,204	43,489		815,693	(29,800)	785,893	3.1%
30-Year Mortgage							

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<b>Coupon Rate:</b>							
3.00%	23,594	1,123		24,717	(1,665)	23,052	3.0%
3.50%	1,861,948	143,753		2,005,701	(118,601)	1,887,100	3.5%
4.00%	854,657	90,484		945,141	(48,535)	896,606	4.0%
5.50%	95,995	12,697		108,692	(1,864)	106,828	5.5%
6.00%	10,067	1,303		11,370	(261)	11,109	6.0%
	2,846,261	249,360		3,095,621	(170,926)	2,924,695	3.7%
<b>Agency IOs and IIOs(2)</b>							
	N/A	N/A		199,132	3,882	203,014	4.3%
<b>Agency IOs and IIOs accounted for as derivatives (2)(3)</b>							
	N/A	N/A		N/A	N/A	99,574	5.0%
	N/A	N/A		199,132	3,882	302,588	4.5%
<b>Non-Agency RMBS</b>							
	280,834	(32,652)	(69,426)	178,756	(249)	178,507	1.0%
<b>Total: Non GAAP Basis-Including</b>							
Linked Transaction	\$ 3,899,299	\$ 260,197	(69,426)	\$ 4,289,202	\$ (197,093)	\$ 4,191,683	3.8%
Linked Transactions	8,153	(1,890)	(1,355)	4,908	25	4,933	0.4%
<b>Total: GAAP Basis-Excluding</b>							
Linked Transaction	\$ 3,891,146	\$ 262,087	(68,071)	\$ 4,284,294	\$ (197,118)	\$ 4,186,750	3.8%

(1) Net weighted average coupon as of June 30, 2013 is presented net of servicing and other fees.

(2) Agency IOs and IIOs and Agency IOs and IIOs, accounted for as derivatives, have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities. At June 30, 2013, the notional balance for Agency IOs and IIOs and for Agency IOs and IIOs, accounted for as derivatives, was \$1,141,218 and \$571,562, respectively.

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

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As of June 30, 2013 and December 31, 2012, our portfolio consisted primarily of fixed rate Agency RMBS which our Manager believes exhibit prepayment mitigation attributes, including Agency RMBS collateralized by low loan balances, loans where the underlying borrower is unable to access the Making Home Affordable Program, including the Home Affordable Refinance Program or HARP or loans which were not originated by third party originators or brokers.

The following table details the constant prepayment rates for our Agency portfolio at June 30, 2013, based on our Manager's estimates at June 30, 2013:

	Low	High
<b>Constant Prepayment Rates</b>		
Agency RMBS		
20-Year Mortgage	3.38%	7.04%
30-Year Mortgage	4.28%	29.80%
Agency IOs and IIOs	3.99%	31.46%
Agency IOs and IIOs accounted for as derivatives	3.59%	20.70%

The following table details information for our Non-Agency portfolio, including linked transactions, at June 30, 2013, based on our Manager's estimates at June 30, 2013:

	Cumulative Default		Cumulative Severity		Cumulative 5-Year CRR	
	Low	High	Low	High	Low	High
Non-Agency RMBS	26.16%	68.16%	39.37%	64.43%	2.51%	6.57%
Non-Agency RMBS Linked Transaction	45.30%	45.30%	48.73%	48.73%	2.71%	2.71%

### **Investment Activity**

*RMBS, Agency Derivatives and Other Securities.* For the three and six months ended June 30, 2013, we acquired approximately \$548.3 million and \$1.6 billion, respectively of Agency RMBS and Agency derivatives, approximately \$9.7 million and \$9.7 million of Agency RMBS included in linked transactions, respectively, approximately \$48.5 million and \$176.1 million of Non-Agency RMBS, respectively, and approximately \$0 million and \$66.7 million Non-Agency RMBS included in linked transactions, respectively. During the same periods, we received principal payments and basis recoveries of approximately \$61.3 million and \$126.2, respectively for Agency RMBS and Agency derivatives, approximately \$58 thousand and \$58 thousand for Agency RMBS included in linked transaction, respectively, approximately \$3.4 million and \$5.2 million for Non-Agency RMBS, respectively and approximately \$415 thousand and \$984 thousand for Non-Agency RMBS included in linked transactions, respectively. Proceeds from sales received for the three and six months ended June 30, 2013 were approximately \$317.2 million and \$2.1 billion, respectively for Agency RMBS and Agency derivatives, approximately \$67.2 million and \$67.2 million for Non-Agency RMBS, respectively and approximately \$21.7 million and \$21.7 million for Non-Agency RMBS included in linked transactions. For the three and six months ended June 30, 2013, we settled certain derivatives realizing a net gain of approximately \$2.4 million and \$2.4 million from the unlinking of securities previously accounted for derivatives through linked transactions, respectively. The average unlevered yield on Agency RMBS, including Agency derivatives, for the three and six months ended June 30, 2013 was approximately 3.01% and 2.98%, respectively and the average unlevered yield on Agency RMBS including linked transactions was approximately 3.01% and 2.98%, respectively. For the same periods, the average unlevered yield on Non-Agency RMBS was approximately 5.96% and 5.93%, respectively and the average unlevered yield on Non-Agency RMBS including linked transactions was approximately 5.97% and 5.87%, respectively.

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For the period from May 15, 2012 (commencement of operations) through June 30, 2012, we acquired approximately \$2.2 billion of Agency RMBS and Agency Derivatives and \$100.7 million of other securities consisting of U.S Treasury Notes. During the same period, we received principal payments of approximately \$8.0 million for Agency RMBS. Proceeds from sales received for the period from May 15, 2012 (commencement of operations) through June 30, 2012 were approximately \$238.9 million for Agency RMBS Agency Derivatives and \$100.9 million for other securities. The average unlevered yield on Agency RMBS for the period from May 15, 2012 (commencement of operations) through June 30, 2012 was 3.04%.



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The following table presents the vintage of our RMBS investment portfolio at June 30, 2013:

	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Agency RMBS														
20-Year Mortgage												13.8%	5.0%	18.8%
30-Year Mortgage						0.3%			0.4%	2.1%	0.1%	53.9%	13.0%	69.8%
Agency Interest-Only- Strips			0.1%	0.1%	0.2%	0.2%		0.3%	0.2%	0.1%	0.2%	3.4%		4.8%
Agency Interest-Only Strips, accounted for as derivatives	0.3%							0.1%		0.4%	0.1%	1.1%	0.3%	2.3%
Non-Agency RMBS		0.1%	0.2%	0.2%	1.0%	2.0%	0.7%							4.2%
Non-Agency Linked Transactions						0.1%								0.1%
Total RMBS	0.3%	0.1%	0.3%	0.3%	1.2%	2.6%	0.7%	0.4%	0.6%	2.6%	0.4%	72.2%	18.3%	100.0%

*Financing and Other Liabilities.* We have entered into repurchase agreements to finance a substantial majority of our RMBS. These agreements are secured by substantially all of our RMBS and bear interest at rates that have historically moved in close relationship to LIBOR. For the three and six months ended June 30, 2013, we received proceeds of approximately \$8.8 billion and \$19.8 billion, respectively and made repayments of approximately \$8.9 billion and \$20.7 billion under repurchase agreements secured by our Agency RMBS. For the same periods, we received proceeds of approximately \$18.6 million and \$18.6 million, respectively and made repayments of approximately \$18.6 million and \$18.6 million under repurchase agreements secured by Agency RMBS included in linked transaction, respectively. We also received proceeds of \$39.0 million and \$39.0 million under repurchase agreements secured by other securities during the three and six months ended June 30, 2013, respectively. In addition, for the three and six months ended June 30, 2013, we received proceeds of approximately \$113.1 million and \$257.4 million under repurchase agreements secured by our Non-Agency RMBS, respectively and an additional \$19.7 million and \$67.6 million under repurchase agreements secured by our Non-Agency RMBS included in linked transactions, respectively. During the same periods, we made repayments of approximately \$97.1 million and \$160.7 million under repurchase agreements secured by our Non-Agency RMBS and \$60.3 million and \$64.3 million under repurchase agreements secured by our Non-Agency RMBS included in linked transactions, respectively.

For the period from May 15, 2012 (commencement of operations) through June 30, 2012, we received proceeds of approximately \$3.2 billion and made repayments of approximately \$1.5 billion under repurchase agreements.

At June 30, 2013, we had outstanding repurchase agreement borrowings with the following 15 counterparties totaling approximately \$4.0 billion, which is a Non-GAAP measure due to our Linked Transactions, which is reconciled to GAAP below as follows:

(dollars in thousands)	Amount Outstanding	Percent of Total	
		Amount Outstanding	Company RMBS Held as Collateral(1)
JP Morgan Securities LLC	617,008	15.6%	662,278
Deutsche Bank Securities LLC	501,528	12.6%	520,985
Goldman Sachs Bank USA	460,891	11.6%	460,269
Barclays Capital Inc.	445,646	11.2%	475,792
Citigroup Global Markets Inc.	381,423	9.6%	382,462
BNP Paribas Securities Corporation.	223,290	5.6%	230,347
Mizuho Securities USA Inc.	221,812	5.6%	229,688
Credit Suisse Securities (USA) LLC	207,602	5.2%	259,313
UBS Securities LLC	174,525	4.4%	179,590

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Merrill Lynch Pierce Fenner & Smith Inc.	161,976	4.2%	164,216
Jefferies & Company Inc.	130,299	3.3%	129,062
Wells Fargo Securities LLC & Wells Fargo Bank N.A.	125,817	3.2%	129,882
South Street Securities LLC	109,036	2.8%	109,699
Morgan Stanley & Co. LLC	104,181	2.6%	107,141
RBC Capital Markets LLC	99,881	2.5%	105,461
Total: Non-GAAP Basis Including Linked Transactions	3,964,915	100.0%	4,146,185
Linked Transactions	3,286		4,933
Total: GAAP Basis Excluding Linked Transactions	3,961,629	100.0%	4,141,252

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(1) At fair value.

We record the liability for RMBS and other securities purchased, for which settlement has not taken place as an investment related payable. As of June 30, 2013, we had investment related payables of approximately \$22.2 million of which no items were outstanding greater than 30 days. Further, each of the counterparties to our repurchase agreements hold collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements.

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The following tables present our borrowings by type of collateral pledged as of June 30, 2013 and 2012, and the respective Effective Cost of Funds (non-GAAP financial measure) for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012 (dollars in thousands) See Non-GAAP financial measures (dollars in thousands):

	Balance (GAAP) June, 2013	Weighted Average Cost of Funds for the three months ended June 30, 2013	Weighted Average Cost of Funds for the six months ended June 30, 2013
<b>Collateral</b>			
Agency RMBS	\$ 3,864,990	0.42%	0.43%
Non-Agency RMBS	96,639	1.85	1.85
Total: Excluding Linked Transactions	\$ 3,961,629	0.45%	0.45%
RMBS Linked Transactions	n/a	n/a	n/a
Total	\$ 3,961,629	0.45%	0.45%

	Balance (Non- GAAP) June 30, 2013	Weighted Average Effective Cost of Funds for the three months ended June 30, 2013(1)	Weighted Average Effective Cost of Funds for the six months ended June 30, 2013(1)
<b>Collateral</b>			
Agency RMBS	\$ 3,864,990	0.94%	0.90%
Non-Agency RMBS	96,639	1.85	1.85
Total: Excluding Linked Transactions	\$ 3,961,629	0.96%	0.91%
Agency RMBS Linked Transactions		0.38	0.38
Non-Agency RMBS Linked Transactions	3,286	1.78	1.80
Total	\$ 3,964,915	0.96%	0.91%

(1) The effective cost of funds for the three and six months ended June 30, 2013, are calculated on an annualized basis and include interest expense for the periods and net payments on interest rate swaps of approximately \$5.2 million and \$9.7 million, respectively, interest payments on Agency linked transactions of approximately \$6 thousand and \$6 thousand, respectively and interest payments on Non-Agency linked transactions of approximately \$99 thousand and \$188 thousand, respectively. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates and are classified as hedges for purposes of satisfying the REIT tax requirements. In addition, although certain securities and their respective repurchase borrowings are classified as derivatives, we view the interest expense attributed to these borrowings as additional cost of funds. See Non GAAP Financial Measures .

	Balance (GAAP) June, 2012	Weighted Average Cost of Funds for the for the period from May 15, 2012 (commencement of operations) through June 30, 2012	Weighted Average Effective Cost of Funds for the for the period from May 15, 2012 (commencement of operations) through June 30, 2012(1)
<b>Collateral</b>			
Agency RMBS	\$ 1,736,493	0.38%	0.76%
Non-Agency RMBS			
Total	\$ 1,736,493	0.38%	0.76%

(1) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net payments on interest rate swaps of approximately \$0.7 million. While swaps are not accounted for using hedge accounting such instruments are viewed by us as an economic hedge against increases in interest rates.

The following table presents our average borrowings, by type of collateral pledged, for the three and six months ended June 30, 2013, and for the period from May 15, 2012 (commencement of operations) through June 30, 2012 (in thousands):

<b>Collateral</b>	<b>For the three months ended June 30, 2013</b>	<b>For the six months ended June 30, 2013</b>	<b>For the period from May 15, 2012 (commencement of operations) through June 30, 2012</b>
Agency RMBS	\$ 3,959,424	\$ 4,243,261	\$ 1,508,909
Non-Agency RMBS	80,375	65,543	
Total: Excluding Linked Transactions	\$ 4,039,799	\$ 4,308,804	\$ 1,508,909
Agency RMBS Linked Transactions	6,301	3,200	
Non-Agency RMBS Linked Transactions	22,370	21,050	
Total	\$ 4,068,470	\$ 4,333,054	\$ 1,508,909
Maximum borrowings during the period (1)	4,231,087	4,808,778	1,736,493

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

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Derivative Instruments. As of June 30, 2013, we had entered into swaps and swaptions designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. The swaps provide for fixed interest rates indexed off of LIBOR and are viewed by us to effectively fix the floating interest rates on approximately \$2.3 billion of borrowings under our repurchase agreements as of June 30, 2013.

The following table presents information about our interest rate swaps as of June 30, 2013 (dollars in thousands):

Remaining Interest Rate	interest rate swap Term	Notional Amount	Average Fixed Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 1 year and less than 3 years		\$ 556,100	0.4%	1.7	26.8%
Greater than 3 years and less than 5 years		411,400	0.9	4.6	
Greater than 5 years		1,333,550	1.9	10.2	30.1
<b>Total</b>		<b>\$ 2,301,050</b>	<b>1.4%</b>	<b>7.1</b>	<b>23.9%</b>

At June 30, 2013, we had entered into four swaptions with a notional amount of \$75.0 million, \$222.5 million, \$750.0 million and \$166.5 million which expire in one month, three months, five months and thirty-five months, respectively. If exercised, we can enter into a 10 year fixed pay swap agreement, a 20 year fixed pay swap agreement, a 10 year fixed pay swap agreement and a 7 year fixed pay swap agreement at a predetermined strike price, respectively.

### *Net Interest Income*

We earned interest income, net of premium amortization and amortization of basis, and inclusive of discount accretion, of approximately \$32.8 million and \$66.5 million for the three and six months ended June 30, 2013 and approximately \$7.1 million for the period from May 15, 2012 (commencement of operations) through June 30, 2012, which represents interest earned on our assets. We incurred interest expense of approximately \$4.5 million and \$9.7 million, for the three and six months ended June 30, 2013, and approximately \$725 thousands for the period from May 15, 2012 (commencement of operations) through June 30, 2012 which was related to borrowings from repurchase agreements.

(dollars in thousands)	For the three months ended June 30, 2013			For the six months ended June 30, 2013		
	Agency	Non-agency	Total	Agency	Non-agency	Total
Average amortized cost of RMBS	\$ 4,274,504	\$ 157,025	\$ 4,431,529	\$ 4,415,030	\$ 133,107	\$ 4,548,137
Total interest income (1)	\$ 30,409	\$ 2,333	\$ 32,742	\$ 62,578	\$ 3,914	\$ 66,492
Yield on average RMBS	2.85%	5.96%	2.96%	2.86%	5.93%	2.95%
Average balance of repurchase agreements	\$ 3,959,424	\$ 80,375	\$ 4,039,799	\$ 4,243,261	\$ 65,543	\$ 4,308,804
Total interest expense	\$ 4,151	\$ 371	\$ 4,522	\$ 9,102	\$ 601	\$ 9,703

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Average cost of funds (2)	0.42%	1.85%	0.45%	0.43%	1.85%	0.45%
Net interest income	\$ 26,258	\$ 1,962	\$ 28,220	\$ 53,476	\$ 3,313	\$ 56,789
Net interest rate spread	2.43%	4.11%	2.51%	2.43%	4.08%	2.50%

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(1) Amount includes net amortization of premiums, accretion of discounts and amortization of basis of approximately \$(15.4) million for Agency, and approximately \$1.7 million for Non-Agency for the three months ended June 30, 2013. For the six months ended June 30, 2013, amount includes net amortization of premiums, accretion of discounts and amortization of basis of approximately \$(33.7) million for Agency and approximately \$2.8 million for Non-Agency. In accordance with GAAP, interest income does not include \$562 thousand and \$997 thousand for linked transactions for the three and six months ended June 30, 2013, respectively; instead they are included in gain on linked transactions.

(2) For the three months ended June 30, 2013, cost of funds does not include accrual and settlement of interest associated with derivative instruments and linked transactions of approximately \$5.2 million and \$105 thousand, respectively. For the six months ended June 30, 2013, cost of funds does not include interest of approximately \$9.7 million associated with derivative instruments and \$194 thousand associated with linked transactions. In accordance with GAAP, those costs are included in gain (loss) on derivative instruments and gain on linked transactions, respectively, in the statement of operations.

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(dollars in thousands)	For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)		
	Agency	Non-agency	Total
Average amortized cost of RMBS	\$ 1,724,206	\$	\$ 1,724,206
Total interest income (1)	\$ 7,083	\$	\$ 7,083
Yield on average RMBS	3.15%		3.15%
Average balance of repurchase agreements	\$ 1,508,909	\$	\$ 1,508,909
Total interest expense	\$ 725	\$	\$ 725
Average cost of funds (2)	0.38%		0.38%
Net interest income	\$ 6,358	\$	\$ 6,358
Net interest rate spread	2.77%		2.77%

(1) Amount includes net amortization of premiums, accretion of discounts and amortization of basis of approximately of \$(1.8) million for Agency for the period from May 15, 2012 (commencement of operations) through June 30, 2012. In accordance with GAAP, interest income does not include linked transactions; instead they are included in gain on linked transactions.

(2) Cost of funds does not include accrual and settlement of interest associated with derivative instruments or linked transactions. In accordance with GAAP, those costs are included in gain (loss) on derivative instruments and gain on linked transactions, respectively, in the statement of operations.

The following tables set forth certain information regarding our net investment income for the three months ended June 30, 2013, See Non-GAAP Financial Measures :

**For the three months ended June 30, 2013:**

**Non-GAAP Financial Measures:**

(dollars in thousands)	Agency	Non-agency	Total
Average amortized cost of RMBS held including Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and linked transactions	\$ 4,381,145	\$ 191,571	\$ 4,572,716
Total interest income including interest income on Agency Interest-Only Strips, Agency Inverse Interest- Only Strips accounted for as derivatives and linked transactions(1)	\$ 32,854	\$ 2,851	\$ 35,705
Yield on average amortized cost of RMBS including adjustments related to cost of Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and linked	3.01%	5.97%	3.14%

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transactions

Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions(2)	\$	9,313	\$	470	\$	9,783
Average cost of funds including interest income (expense) on Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		0.94%		1.83%		0.96%
Net interest income including interest income (expense) on Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$	23,541	\$	2,381	\$	25,922
Net interest rate spread including interest income (expense) on Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions		2.07%		4.14%		2.18%

(1) For the three months ended June 30, 2013 includes net amortization of premiums, accretion of discounts and amortization of basis of approximately \$(17.9) million. This amount is composed of approximately \$(15.4) million for Agency RMBS included in interest income, approximately \$1.7 million for Non-Agency included in interest income, \$(9) thousand for Agency linked transactions (Non-GAAP measure), \$0.4 million for Non-Agency linked transactions (Non-GAAP measure) and \$(4.6) million of amortization of basis on Agency Interest-Only Strips and Agency Inverse Interest Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

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



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**For the six months ended June 30, 2013:**

**Non-GAAP Financial Measures:**

(dollars in thousands)

	Agency	Non-agency	Total
Average amortized cost of RMBS held including Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and linked transactions	\$ 4,513,039	\$ 167,291	\$ 4,680,330
Total interest income including interest income on Agency Interest-Only Strips, Agency Inverse Interest- Only Strips accounted for as derivatives and linked transactions(1)	\$ 66,781	\$ 4,867	\$ 71,648
Yield on average amortized cost of RMBS including adjustments related to cost of Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and linked transactions	2.98%	5.87%	3.09%
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions(2)	\$ 18,846	\$ 789	\$ 19,635
Average cost of funds including interest income (expense) on Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	0.89%	1.84%	0.91%
Net interest income including interest income (expense) on Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$ 47,935	\$ 4,078	\$ 52,013
Net interest rate spread including interest income (expense) on Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	2.09%	4.03%	2.18%

(1) For the six months ended June 30, 2013 includes net amortization of premiums, accretion of discounts and amortization of basis of approximately \$(38.9) million. This amount is composed of approximately \$(33.7) million for Agency RMBS included in interest income, approximately \$2.8 million for Non-Agency included in interest income, \$(9) thousand for Agency linked transactions (Non-GAAP measure), \$0.8 million for Non-Agency linked transactions (Non-GAAP measure) and \$(8.8) million of amortization of basis on Agency Interest-Only Strips and Agency Inverse Interest Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

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

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**For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2):**

**Non-GAAP Financial Measures:**

(dollars in thousands)

	Agency	Non-agency	Total
Average amortized cost of RMBS held including Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and linked transactions	\$ 1,752,229	\$	\$ 1,752,229
Total interest income including interest income on Agency Interest-Only Strips, Agency Inverse Interest- Only Strips accounted for as derivatives and linked transactions(1)	\$ 7,915	\$	\$ 7,915
Yield on average amortized cost of RMBS including adjustments related to cost of Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and linked transactions	3.51%		3.51%
Total interest expense including interest income (expense), net incurred on interest rate swaps and interest expense incurred on linked transactions(2)	\$ 1,450	\$	\$ 1,450
Average cost of funds including interest income (expense) on Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	0.76%		0.76%
Net interest income including interest income (expense) on Agency Interest-Only Strips, Agency Inverse Interest-Only Strips accounted for as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	\$ 6,465	\$	\$ 6,465
Net interest rate spread including interest income (expense) on Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted as derivatives and interest income (expense), net incurred on interest rate swaps and linked transactions	2.75%		2.75%

(1) For period from May 15, 2012 (commencement of operations) through June 30, 2012 includes net amortization of premiums, accretion of discounts and amortization of basis of approximately \$(1.9) million. This amount is composed of approximately \$(1.8) million for Agency RMBS included in interest income and \$(0.1) million of amortization of basis on Agency Interest-Only Strips and Agency Inverse Interest Only Strips accounted for as derivatives (Non-GAAP measure), not reported in interest income for GAAP (included in Loss on derivative instruments).

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

Interest income is subject to interest rate risk. Refer to Item 3 Quantitative and Qualitative Disclosures about Market Risk, for more information relating to interest rate risk and its impact on our operating results.

**Other Income (Loss)**

The following tables present the sales of our RMBS (dollars in thousands).

	For the three months ended June 30, 2013			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS	\$ 317,170	\$	\$ (10,462)	\$ (10,462)
Non-Agency RMBS	67,184	4,379		4,379
Total	\$ 384,354	\$ 4,379	\$ (10,462)	\$ (6,083)

	For the six months ended June 30, 2013			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS				
(1)	\$ 2,145,888	\$ 8,646	\$ (30,867)	\$ (22,221)
Non-Agency RMBS	67,184	4,379		4,379
Total	\$ 2,213,072	\$ 13,025	\$ (30,867)	\$ (17,842)

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

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For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)				
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS	\$ 238,872	\$ 983	\$ (25)	\$ 958
Other Securities	100,854	199		199
Total	\$ 339,726	\$ 1,182	\$ (25)	\$ 1,157

We sold these RMBS in order to: (i) adjust the prepayment characteristics of our portfolio; or (ii) adjust the duration of our portfolio.

With respect to our RMBS, we elected the fair value option and, as a result, we record the change in fair value related to RMBS in earnings. The following tables present amounts related to realized gains and losses as well as changes in fair value of our RMBS portfolio and derivative instruments that are included in our statement of operations for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012 (dollars in thousands):

**For the three months ended June 30, 2013:**

Description	Realized Gain (Loss), net(1)	Contractual interest income (expense), net	Other loss on Residential mortgage -backed securities	Unrealized Gain (Loss), net	Basis Recovery	Mark-to-market adjustments	Total
RMBS and Other Securities	\$ (6,083)	\$	\$ (3,533)	\$ (156,286)	\$	\$	\$ (165,902)
Cash and cash equivalents		12					12
Derivative Instruments:							
Interest rate swaps	23,881	(5,156)				71,202	89,927
Interest rate swaptions	1,038					20,751	21,789
Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted for as derivatives		7,032			(4,631)	3,633	6,034
Options	(925)					324	(601)
TBAs	(3,164)					(4,511)	(7,675)
Linked Transactions	3,748	30				131	3,909
Total	\$ 18,495	\$ 1,918	\$ (3,533)	\$ (156,286)	\$ (4,631)	\$ 91,530	\$ (52,507)

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

**For the six months ended June 30, 2013:**

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Description	Realized Gain (Loss), net(1)	Contractual interest income (expense), net	Other loss on Residential mortgage -backed securities	Unrealized Gain (Loss), net	Basis Recovery	Mark-to- market adjustments	Total
RMBS and Other							
Securities	\$ (17,743)	\$	\$ (5,801)	\$ (211,045)	\$	\$	\$ (234,589)
Cash and cash equivalents		45					45
Derivative Instruments:							
Interest rate swaps	42,139	(9,738)				73,060	105,461
Interest rate swaptions	1,038					19,245	20,283
Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted for as derivatives	(99)	12,975			(8,816)	1,285	5,345
Options	(925)						(925)
TBAs	(2,563)					(3,287)	(5,850)
Linked Transactions	3,748	46				711	4,505
Total	\$ 25,595	\$ 3,328	\$ (5,801)	\$ (211,045)	\$ (8,816)	\$ 91,014	\$ (105,725)

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

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For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2):

Description	Realized Gain (Loss), net(1)	Contractual interest income (expense), net	Other loss on Residential mortgage -backed securities	Unrealized Gain (Loss), net	Basis Recovery	Mark-to- market adjustments	Total
RMBS and Other Securities	\$ 1,157	\$	\$ (87)	\$ 2,983	\$	\$	\$ 4,053
<b>Derivative Instruments:</b>							
Interest rate swaps	4	(726)				(5,044)	(5,766)
Interest rate swaptions							
Agency Interest-Only Strips and Agency Inverse Interest-Only Strips accounted for as derivatives		954			(122)	(225)	607
Options TBAs							
Linked Transactions							
Total	\$ 1,161	\$ 228	\$ (87)	\$ 2,983	\$ (122)	\$ (5,269)	\$ (1,106)

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

In order to mitigate interest rate risk resulting from our repurchase agreements, we entered into interest rate swaps with an aggregate notional amount of approximately \$2.3 billion and interest rate swaptions with an aggregate notional amount of approximately \$1.2 billion. While not designated as a hedge for accounting purposes, our interest rate swaps and interest rate swaptions are viewed as an economic hedge on a portion of our floating-rate borrowings. Since we do not apply hedge accounting for our interest rate swaps and interest rate swaptions, we record the change in fair value related to such agreements in earnings as unrealized gain or loss on derivative instruments. Included in realized gain or loss on derivative instruments are the net interest rate swap payments (including accrued amounts) associated with our interest rate swaps.

**Expenses****General and Administrative Expenses**

We incurred general and administrative expenses of approximately \$1.5 million and approximately \$3.3 million for the three and six months ended June 30, 2013, respectively and approximately \$584 thousand for the period from May 15, 2012 (commencement of operations) through June 30, 2012, which represents professional fees, insurance, non-cash stock based compensation and overhead costs of the Company.

**Management Fee Expense**

We incurred management fee expense of approximately \$1.8 million and approximately \$3.9 million for the three and six months ended June 30, 2013 and approximately \$407 thousand for the period from May 15, 2012 (commencement of operations) through June 30, 2012, of which approximately \$2.0 million was payable at June 30, 2013 to our Manager under the Management Agreement. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears.

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

**Dividends**

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

Declaration Date	Record Date	Payment Date	Amount per Share	Tax Characterization
<b>2013</b>				
April 1, 2013	April 12, 2013	April 30, 2013	\$ 0.95	Not yet determined
June 20, 2013	July 1, 2013	July 29, 2013	\$ 0.90	Not yet determined
<b>2012</b>				
July 26, 2012	August 6, 2012	August 14, 2012	\$ 0.38	Ordinary income
September 20, 2012	October 1, 2012	October 28, 2012	\$ 0.85	Ordinary income
December 19, 2012	December 31, 2012	January 29, 2013	\$ 1.12	Ordinary income

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**Liquidity and Capital Resources**

*General*

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

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

Under our repurchase agreements and derivative contracts, lenders and counterparties retain the right to determine the fair value of the collateral pledged. A reduction in the value of the collateral pledged will require us to provide additional collateral or fund cash margin calls.

Additionally, since margins calls for our interest rate swaps and swaptions generally are inversely correlated to those of our repurchase agreements, whereby our counterparties would be required to post collateral with us. As one would anticipate, the recent volatility in the fixed income markets and, in particular, the sell-off in Agency RMBS resulted in demands for additional collateral from our repurchase agreement counterparties. Similarly, we received incremental collateral from our interest rate swap and swaption counterparties in the form of U.S. Treasuries. We were able to satisfy our additional collateral requirements with unpledged securities in our portfolio, cash on hand and cash received from repurchase agreements we entered into using the U.S. Treasuries we had received as collateral. We were not forced to sell any of our assets, nor did any of counterparties sell any of assets held by them as collateral. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, we could be required to sell securities, possibly even at a loss to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on our financial position, results of operations and cash flows.

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

Our primary sources of liquidity are as follows:

*Cash Generated from Initial Public Offering, Concurrent Private Placements and Follow-On Public Offering*

On May 15, 2012, we completed our IPO and concurrent private placements generating net proceeds of approximately \$204.4 million. On October 3, 2012, we completed a follow-on public offering generating net proceeds of approximately \$301.0 million.



**Borrowing under Various Financing Arrangements**

As of June 30, 2013, we had master repurchase agreements with 17 counterparties. We had borrowings under repurchase agreements with 15 counterparties of approximately \$4.0 billion at June 30, 2013. The following tables present our borrowings by type of collateral pledged as of June 30, 2013, and the respective effective cost of funds (non-GAAP financial measure) for the three and six months then ended (dollars in thousands) and for the period from May 15, 2012 (commencement of operations) through June 30, 2012. See Non-GAAP Financial Measures (dollars in thousands):

<b>Collateral</b>	<b>Repurchase Agreement Borrowings Outstanding June 30, 2013</b>	<b>Fair Value of Collateral Pledged (1)</b>	<b>Weighted Average Interest Rate end of period</b>	<b>Weighted Average Cost of Funds for the three months ended June 30, 2013</b>	<b>Weighted Average Effective Cost of Funds for the three months ended June 30, 2013 (2)</b>	<b>Weighted Average Cost of Funds for the six months ended June 30, 2013</b>	<b>Weighted Average Effective Cost of Funds for the six months ended June 30, 2013 (2)</b>
Agency RMBS	\$ 3,864,990	\$ 3,996,749	0.40%	0.42%	0.94%	0.43%	0.90%
Non-Agency RMBS	96,639	144,503	1.79	1.85	1.85	1.85	1.85
Total:							
Excluding Linked Transactions	\$ 3,961,629	\$ 4,141,252	0.44%	0.45%	0.96%	0.45%	0.91%
Agency RMBS Linked Transactions			n/a	n/a	0.38	n/a	0.38
Non-Agency RMBS Linked Transactions	3,286	4,933	1.70	n/a	1.78	n/a	1.80
Total	\$ 3,964,915	\$ 4,146,185	0.44%	0.45%	0.96%	0.45%	0.91%

(1) Excludes approximately \$123.2 million of cash collateral posted.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the periods and net payments on interest rate swaps of approximately \$9.7 million and approximately \$5.2 million and interest expense on linked transactions of approximately \$105 thousand and approximately \$195 thousand for the three and six months ended June 30, 2013, respectively. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates and are treated as hedges for purposes of satisfying the REIT tax requirements. See Non-GAAP Financial Measures .

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Collateral	Repurchase Agreement Borrowings Outstanding June 30, 2012	Fair Value of Collateral Pledged (1)	Weighted Average Interest Rate end of period	Weighted Average Cost of Funds for the period from May 15, 2012 (commencement of operations) through June 30, 2012	Weighted Average Effective Cost of Funds for the period from May 15, 2012 (commencement of operations) through June 30, 2012 (2)
Agency RMBS	\$ 1,736,493	\$ 1,819,089	0.42%	0.38%	0.76%
Total	\$ 1,736,493	\$ 1,819,089	0.42%	0.38%	0.76%

(1) Includes \$0 of cash collateral for Agency RMBS.

(2) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net payments on interest rate swaps of approximately \$0.7 million. While interest rate swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates and are treated as hedges for purposes of satisfying the REIT tax requirements. See Non-GAAP Financial Measures .

As of June 30, 2013, our transactions under repurchase agreements with 17 counterparties for RMBS, require collateral in excess of the loan amount, or haircuts, ranging from a low of 3.0% to a high of 5.5% for Agency RMBS, exclusive of IOs and IIOs for which the haircuts are as high as 30.0%, and for Non-Agency RMBS for which the haircuts range from a low of 20% to a high of 45%. Declines in the value of our portfolio can trigger margin calls by our lenders under our repurchase agreements. Margin calls could adversely affect our liquidity. Our inability to post adequate collateral for a margin call by the counterparty could result in a condition of default under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all existing repurchase transactions with us and require any amount due to the counterparties by us to be payable immediately. In which case, we may be forced to sell assets under adverse market conditions or through foreclosure which may have a material adverse consequence on our business and our results of operations. During the three months ended June 30, 2013, we incurred a number of margin calls which we satisfied using cash on hand, including cash proceeds generated from repurchase agreements in which we pledged U.S. Treasuries received from our swap counterparties as additional collateral. No event of default occurred.

Under the repurchase agreements and derivative contracts, the respective lenders and counterparties, subject to the terms of the individual agreements, retain the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires us to provide additional collateral or fund margin calls. In addition, certain of the repurchase agreements may be terminated by our counterparties if we do not maintain certain equity and leverage metrics. We are compliant with these tests at June 30, 2013. RMBS held by counterparties as security for repurchase agreements totaled approximately \$4.1 billion. U.S. Treasuries held by counterparties as security for repurchase agreements totaled approximately \$41.3 million.

Accordingly, we may also be required to pledge cash or securities as collateral as part of a margin arrangement, calculated daily, in connection with the swaps. The amount of margin that we are required to post will vary by counterparty and generally reflects collateral posted with respect to swaps that are in an unrealized loss position to us and a percentage of the aggregate notional amount of swaps per counterparty. Conversely, if our swaps are in an unrealized gain position, our counterparties are required to post collateral with us, under the same terms that we post collateral with them.



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Cash collateral held by counterparties at June 30, 2013 was approximately \$134.4 million, which is included in Due from counterparties on our balance sheet, comprised of approximately \$123.2 million held in connection with repurchase borrowings and approximately \$11.2 million held by our interest rate swap counterparties. At June 30, 2013, March 31, 2013, December 31, 2012, and June 30, 2012, we held U.S. Treasury securities of approximately \$94.4 million, \$5.1 million, \$0 and \$0, respectively, as posted collateral by our swap counterparties. Of the \$94.4 million held at June 30, 2013, \$39.8 million was posted as collateral for borrowings under repurchase agreements, reflected as Due to counterparties on our Balance Sheet and approximately \$1.5 million was posted with one of our repurchase agreement counterparties to satisfy a margin call. In addition, at June 30, 2013, March 31, 2013, December 31, 2012, and June 30, 2012, we held securities of approximately \$1.5 million, \$3.7 million, \$2.6 million and \$5.6 million, respectively, received as collateral from our repurchase agreement counterparties to satisfy margin requirements.

We had approximately \$22.2 million of unsettled securities as of June 30, 2013, which would have increased our total outstanding borrowing balance at such time if the purchases had been settled with repurchase agreements at or prior to June 30, 2013.

***Cash Generated from Operations***

Our operating activities provided net cash of approximately \$93.6 million and approximately \$1.3 million for the six months ended June 30, 2013 and for the period May 15, 2012 (commencement of operations) through June 30, 2012, respectively. The cash provided by operating activities was primarily a result of our net interest income, which is interest income less interest expense. Our net loss for the six months ended June 30, 2013 was approximately \$56.2 million and our net income for the period from May 15, 2012 (commencement of operations) through June 30, 2012 was approximately \$4.3 million. Included in our net loss for the six months ended June 30, 2013 and net income for the period from May 15, 2012 (commencement of operations) through June 30, 2012, were non-cash items that do not affect cash such as amortization of the premium and accretion of the discount on our RMBS, unrealized gain/(loss) on securities, mark-to-market adjustments on derivatives, mark-to-market adjustment on linked transactions and other losses on residential mortgage-backed securities. Also, included in net loss for the six months ended June 30, 2013 were net realized losses on sale of securities of approximately \$17.7 million and included in net income for the period from May 15, 2012 (commencement of operations) through June 30, 2012 were net realized gains on the sale of securities of approximately \$1.2 million. For the six months ended June 30, 2013, net realized losses on derivatives of approximately \$2.5 million and net realized gains of approximately \$3.7 million on sale of securities underlying linked transactions were also included in net loss for the period. During the same periods, net cash from operations was increased by approximately \$1.6 million and decreased by approximately \$5.8 million, respectively resulting from an increase and a decrease in our operating liabilities over operating assets, respectively.

***Cash Provided by and Used in Investing Activities***

Our investing activities provided net cash of approximately \$785.8 million for the six months ended June 30, 2013 and used net cash of approximately \$1.9 billion for the period from May 15, 2012 (commencement of operations) through June 30, 2012. During these periods, we utilized cash to purchase approximately \$1.7 billion and approximately \$2.2 billion of RMBS, which was offset by proceeds from asset sales of approximately \$2.2 billion and \$237.4 million and principal payments and basis recovered of approximately \$157.0 million and \$8.4 million, respectively. In addition, during the six months ended June 30, 2013 we used cash to purchase securities underlying linked transactions of approximately \$76.4 million, which was offset by proceeds from asset sales of approximately \$21.7 million and principal repayments on securities underlying linked transactions of approximately \$1.0 million. For the six months ended June 30, 2013, we utilized cash to pay approximately \$28.2 million of premiums for derivatives which was offset by receipt of premiums of approximately \$3.8 million. We also received proceeds from settlement of derivatives of approximately \$222.6 million for the six months ended June 30, 2013.

*Other Potential Sources of Financing*

We held cash of approximately \$8.7 million at June 30, 2013. Our primary sources of cash currently consist of repurchase facility borrowings, investment income and the proceeds of any future securities offerings, to the extent available in the capital market. In the future, we expect our primary sources of liquidity to consist of payments of principal and interest we receive on our portfolio of assets, unused borrowing capacity under our financing sources and future issuances of equity and debt securities.

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

Table of Contents**Contractual Obligations and Commitments**

Our contractual obligations as of June 30, 2013 are as follows (dollars in thousands):

	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years	Total
Borrowings under repurchase agreements (including linked transactions)	\$ 3,964,915			\$ 3,964,915	3,964,915
Due to counterparties	39,000				39,000
TBA long positions	107,673				107,673
Total: Non-GAAP Basis Including Linked Transactions	\$ 4,111,588			\$ 4,111,588	4,111,588
Linked Transactions	3,286				3,286
Total: GAAP Basis Excluding Linked Transactions	\$ 4,108,302			\$ 4,108,302	4,108,302

We enter into a linked transaction when the initial transfer of a financial asset and repurchase financing are entered into contemporaneously with, or in contemplation of, one another. In this situation, we then record the initial transfer and repurchase financing on a net basis. The fair value of linked transactions reflects the value of the underlying real estate securities and linked repurchase agreement borrowings; resulting in an embedded repurchase agreement. As of June 30, 2013, we had one linked transaction resulting in approximately \$3.3 million of embedded repurchase agreements with a weighted average rate of 1.70%. The weighted average contractual maturity of the repurchase agreements was 26 days.

As of June 30, 2013, we have an obligation for approximately \$2.9 million in contractual interest payments related to our repurchase agreements, including linked transactions of approximately \$9 thousand through the respective maturity date of each repurchase agreement.

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

On May 9, 2012, we entered into a management agreement (the Management Agreement) with our Manager pursuant to which our Manager is entitled to receive a management fee and reimbursement of certain expenses. Our Manager is responsible for: (i) performing all of our day-to-day functions, other than those provided by our chief financial officer; (ii) determining investment criteria in conjunction with our board of directors; (iii) sourcing, analyzing and executing investments, asset sales and financings; (iv) performing asset management duties; and (v) performing financial and accounting management, subject to the direction and oversight of our board of directors. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity, calculated and payable (in cash) quarterly in arrears. For purposes of calculating the management fee, stockholders' equity means the sum of the net proceeds from any issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings, calculated in accordance with GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid for repurchases of our shares of common stock, excluding any unrealized gains, losses or other non-cash items that have impacted stockholders' equity as reported in our financial statements prepared in accordance with GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in GAAP and certain other non-cash charges and certain other non-cash

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charges, including OTTI charges reported in other loss on RMBS, unrealized gain on RMBS and other securities and non-cash portion of loss on derivative instruments, after discussions between our Manager and our independent directors and after approval by a majority of our independent directors. However, if our stockholders' equity for any given quarter is negative based on the calculation described above, our Manager will not be entitled to receive any management fee for that quarter.

In addition, under the Management Agreement, we are required to reimburse our Manager for the expenses described below. Expense reimbursements to the Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation. Because our Manager's personnel perform certain legal, accounting, due diligence tasks and other services that outside professionals or outside consultants otherwise would perform, our Manager is paid or reimbursed for the documented cost of performing such tasks, provided that such costs and reimbursements are in amounts which are no greater than those which would be payable to outside professionals or consultants engaged to perform such services pursuant to agreements negotiated on an arm's-length basis. For the six months ended June 30, 2013, our Manager did not request any such reimbursements, exclusive of certain salary or employee benefits associated with our sole employee, and certain de-minimis expenses paid by our Manager on our behalf.

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

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

**Off-Balance Sheet Arrangements**

Our linked transactions are comprised of real estate securities, associated repurchase agreements and interest receivable/payable on such accounts. The extent to which these transactions become unlinked in the future, the underlying real estate securities and the borrowings under repurchase agreements and associated interest income and expense will be presented on a gross basis on our balance sheet and statement of operations, prospectively. As of June 30, 2013, our maximum exposure to loss on linked transactions was \$4.9 million.

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

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

See Warrants above for a description of our outstanding warrants.

**Dividends**



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

### **Non-GAAP Financial Measures**

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

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Total interest income including interest income on Agency Interest-Only Strips and Agency Inverse Interest-Only Strips classified as derivatives and Effective Cost of Funds for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012, constitutes a non-GAAP financial measure within the meaning of Regulation G promulgated by the SEC. We believe that the measures presented in this quarterly report on Form 10-Q, when considered together with U.S. GAAP financial measures, provide information that is useful to investors in understanding our borrowing costs and net interest income, as viewed by us. An analysis of any non-GAAP financial measure should be made in conjunction with results presented in accordance with GAAP.

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

The following table reconciles total interest income to interest income including interest income on Agency Interest-Only and Agency Inverse Interest-Only Strips classified as derivatives and interest income on linked transactions (non-GAAP financial measure) for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012:

(in thousands)	For the three months ended June 30, 2013	For the six months ended June 30, 2013	For the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised (See Note 2)
Coupon Interest	\$ 46,411	\$ 97,412	\$ 8,912
Premium accretion, discount amortization and amortization of basis, net	(13,669)	(30,920)	(1,829)
Interest Income	\$ 37,742	\$ 66,492	\$ 7,083
<b>Contractual Interest income, net of amortization basis on Agency Interest-Only and Interest Strips, classified as derivatives(1):</b>			
Coupon Interest	\$ 7,032	\$ 12,975	\$ 954
Amortization of basis (Non-GAAP Financial Measure)	(4,631)	(8,816)	(122)
<b>Contractual Interest income, net of discount amortization on Linked Transactions (2):</b>			
Coupon Interest	134	240	
Discount amortization	428	757	
Subtotal	2,963	5,156	832
Total interest income, including interest income on Agency Interest-Only Strips, classified as derivatives - Non-GAAP Financial Measure	\$ 35,705	\$ 71,648	\$ 7,915

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

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

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

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The following table reconciles the Effective Cost of Funds (non-GAAP financial measure) with interest expense for the three and six months ended June 30, 2013:

(dollars in thousands)	For the three months ended June 30, 2013		For the six months ended June 30, 2013	
	Reconciliation	Cost of Funds/Effective Borrowing Costs	Reconciliation	Cost of Funds/Effective Borrowing Costs
Interest expense	\$ 4,522	0.45%	\$ 9,703	0.45%
Interest expense on linked transactions	105	1.47%	194	1.61%
Net interest paid - interest rate swaps	5,156	0.51%	9,738	0.46%
Effective Borrowing Costs - Non-GAAP Financial Measure	\$ 9,783	0.96%	\$ 19,635	0.91%
Weighted average repurchase borrowings(1)	4,068,470		4,333,054	

(1) Includes average repurchase borrowings under linked transactions.

The following table reconciles the Effective Cost of Funds (non-GAAP financial measure) with interest expense for the period from May 15, 2012 (commencement of operations) through June 30, 2012:

(dollars in thousands)	Reconciliation	Cost of Funds/Effective Borrowing Costs
Interest expense	\$ 725	0.38%
Net interest paid - interest rate swaps	725	0.38%
Effective Borrowing Costs - Non-GAAP Financial Measure	\$ 1,450	0.76%
Weighted average repurchase borrowings	1,508,909	

### *Core Earnings*

Our Core Earnings were approximately \$22.8 million and approximately \$45.4 for the three and six months ended June 30, 2013, respectively and approximately \$5.5 million for the period from May 15, 2012 (commencement of operations) through June 30, 2012. Core Earnings is a non-GAAP financial measure that is used by us to approximate cash yield or income associated with our portfolio and is defined as GAAP net income (loss) as adjusted, excluding: (i) net realized gain (loss) on investments and derivative contracts; (ii) net unrealized gain (loss) on investments; (iii) loss resulting from mark-to-market adjustments on derivative contracts; (iv) other loss on RMBS; (v) non-cash stock-based compensation expense; and (vi) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the us, the Manager and our independent directors and after approval by a majority of the our independent directors.

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

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

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The table below summarizes the reconciliation from Net income (loss) to Core Earnings for the three and six months ended June 30, 2013 and for the period from May 15, 2012 (commencement of operations) through June 30, 2012:

(dollars in thousands)	For the three months ended June 30, 2013	For the six months ended June 30, 2013	for the period from May 15, 2012 (commencement of operations) through June 30, 2012, as Revised
Net income (loss) GAAP	\$ (27,654)	\$ (56,153)	\$ 4,261
Adjustments:			
<i>RMBS and other securities:</i>			
Unrealized (gain) loss on RMBS	156,286	211,045	(2,983)
Other loss on Residential mortgage-backed securities	3,533	5,801	87
Realized (gain) loss on sale of RMBS	6,083	17,743	(1,157)
<i>Derivative Instruments:</i>			
Realized gain on termination of interest rate swaps	(23,881)	(42,139)	(4)
Realized loss on settlement of TBAs	3,163	2,563	
Realized loss on expiration of option derivatives	925	925	
Realized gain on sale of swaptions	(1,038)	(1,038)	
Realized gain on sale of securities underlying linked transactions	(3,748)	(3,748)	
Realized loss on Agency Interest-Only Strips accounted for as derivatives		99	
Mark-to-market adjustments on interest rate swaps	(71,202)	(73,060)	5,044
Mark-to-market adjustments on interest rate swaptions	(20,751)	(19,245)	
Mark-to-market adjustments on options	(324)		
Mark-to-market adjustments on TBAs	4,511	3,287	
Mark-to-market adjustments on linked transactions	296	46	
Mark-to-market adjustments on derivative instruments	(3,633)	(1,284)	225
Non-cash stock-based compensation expense	251	537	54
Total adjustments	50,471	101,532	1,266
Core Earnings Non-GAAP Financial Measure	\$ 22,817	\$ 45,379	\$ 5,527
Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure			
	\$ 0.94	\$ 1.87	\$ 0.53
Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure			
	\$ 0.94	\$ 1.86	\$ 0.53
Basic weighted average common shares and participating securities			
	24,305,631	24,256,175	10,334,824

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Diluted weighted average common shares and participating securities	24,374,608	24,357,358	10,334,824
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*Revision of Core Earnings for the period from May 15, 2012 (commencement of operations) through June 30, 2012*

As previously reported in our annual report on Form 10-K for 2012, during the process of preparing our 2012 financial statements, we discovered that the methodology that was used to accrete interest income and to amortize the cost basis of certain of the our residential mortgage backed securities, which was based on a third party vendor's system, as well as the presentation with regard to certain items in our Statement of Cash Flows were not in accordance with GAAP. The resulting correction of these errors resulted in a reclassification of a portion of our previously reported net interest income to realized and unrealized gains and as a result this impacted our previously reported Core Earnings for the period from May 15, 2012 (commencement of operations) through June 30, 2012. Core Earnings for the period from May 15, 2012 (commencement of operations) through June 30, 2012 increased from approximately \$4.8 million or \$0.47 per fully diluted share to approximately \$5.5 million or \$0.53 per fully diluted share.

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The tables below summarize the reconciliation from Net Income to Core Earnings for the period from May 15, 2012 (commencement of operations) through June 30, 2012, as revised.

(dollars in thousands)		For the period from May 15, 2012 (commencement of operations) through June 30, 2012		
		As Originally Reported	Adjustments	As Revised
Net Income	GAAP	\$ 4,261	\$	\$ 4,261
Adjustments:				
<i>RMBS and other securities:</i>				
Unrealized gain on RMBS		(3,925)	942	(2,983)
Other loss on Residential mortgage-backed securities		605	(518)	87
Realized gain on sale of RMBS		(1,120)	(37)	(1,157)
<i>Derivative Instruments:</i>				
Realized loss on termination of interest rate swaps			(4)	(4)
Mark-to- market adjustments on interest rate swaps		4,968	76	5,044
Mark-to- market adjustments on interest rate swaptions				
Mark-to- market adjustments on TBAs				
Mark-to-market adjustments on derivative instruments			347	347
Basis amortization of Agency Interest-Only Strips accounted for as derivatives			(122)	(122)
Realized loss on Agency Interest-Only Strips accounted for as derivatives				
Non-cash stock-based compensation expense		54		54
Total adjustments		582	684	1,266
Core Earnings	Non-GAAP Financial Measure	\$ 4,843	\$ 684	\$ 5,527
Basic Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure				
		\$ 0.47	\$ 0.06	\$ 0.53
Diluted Core Earnings per Share of Common Stock and Participating Securities - Non-GAAP Financial Measure				
		\$ 0.47	\$ 0.06	\$ 0.53
Basic weighted average common shares and participating securities				
		10,334,824	10,334,824	10,334,824



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Diluted weighted average common shares and participating securities	10,334,824	10,334,824	10,334,824
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**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk.**

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

***Credit Risk***

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

As of June 30, 2013, each of the 15 counterparties that we had outstanding repurchase agreement borrowings withheld collateral which we posted as security for such borrowings in excess of 5% of our Stockholders' equity. Prior to entering into a repurchase agreement with any particular institution, our Manager does a thorough review of such potential counterparty. Such review, however, does not assure the creditworthiness of such counterparty nor that the financial wherewithal of the counterparty will not deteriorate in the future.

***Interest Rate Risk***

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

***Interest Rate Effect on Net Interest Income***

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

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

*Interest Rate Cap Risk*

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

Table of Contents***Interest Rate Effects on Fair value***

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

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

***Market Risk***

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

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments, including interest rate swaps, Agency Interest-Only Strips, Agency Inverse Interest-Only Strips, and net interest income at June 30, 2013, assuming a static portfolio of assets. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilizes our Manager's assumptions, models and estimates, which are based on our Manager's judgment and experience.

Change in Interest Rates	Percentage Change in Projected	Percentage Change in Projected
	Net Interest Income	Portfolio Value
+1.00%	(16.00)%	(0.12)%
+0.50%	(7.50)%	(0.12)%
-0.50%	(2.71)%	0.03%
-1.00%	NA(1)	NA(1)

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

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

While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the

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impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and derivative instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above and such difference might be material and adverse to our stockholders.

Certain assumptions have been made in connection with the calculation of the information set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at June 30, 2013. The analysis presented utilizes assumptions and estimates based on our Manager's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk, future purchases and sales of assets could materially change our interest rate risk profile.

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***Prepayment Risk***

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

***Counterparty Risk***

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

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

If a counterparty to an interest rate swap cannot perform under the terms of the interest rate swap, we may not receive payments due under that agreement, and thus, we may lose any unrealized gain associated with the interest rate swap. We may also risk the loss of any collateral we have pledged to secure our obligations under interest rate swap if the counterparty becomes insolvent or files for bankruptcy. In addition, the interest rate swap would no longer mitigate the impact of changes in interest rates as intended. Also see [Liquidity Risk](#) below.

***Funding Risk***

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

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

*Liquidity Risk*

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

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

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

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

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

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

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

***Inflation***

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily directly correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our distributions will be determined by our board of directors consistent with our obligation to distribute to our stockholders at least 90% of our net taxable income on an annual basis in order to maintain our REIT qualification. In each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

**ITEM 4. Controls and Procedures.**

(a) Evaluation of Disclosure Controls and Procedures

A review and evaluation was performed by the Company's management, including the Company's Chief Executive Officer (the "CEO") and Chief Financial Officer (the "CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of June 30, 2013, the end date of the period covered by this quarterly report on Form 10-Q, as well as March 31, 2013. 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 Company's periodic reports.



As described below, management has identified a material weakness in the Company's internal control over financial reporting and accordingly has concluded that the Company's disclosure controls and procedures were not effective to give reasonable assurances to the timely collection, evaluation and disclosure of information relating to the Company that would potentially be subject to disclosure under the Exchange Act and the rules and regulations promulgated thereunder. Internal control over financial reporting is an integral component of the Company's disclosure controls and procedures. Solely as a result of this material weakness described below, the Company's management, including the CEO and CFO have concluded that the Company's disclosure controls and procedures were not effective as of March 31, 2013 or June 30, 2013.

(b) Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP, and includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

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

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In connection with the preparation of the Company's financial statements included in its annual report on Form 10-K, the Company discovered that the methodology used to accrete interest income and to amortize the cost basis of certain of the Company's investments in RMBS did not comply with GAAP. In order to correct these errors, the Company reclassified a portion of the Company's net interest income to both realized and unrealized gains, and certain amounts previously reflected in operating cash flows to investing cash flows.

The Company has implemented procedures in the first quarter of 2013 to remediate the material weakness which include confirming on no less than a quarterly basis: (i) the accuracy of prepayments speeds provided by the Company and utilized by its third party vendor; (ii) the implementation, application and methodology used by its third party vendor for purposes of calculating interest income accretion or amortization of the cost basis for each category of RMBS in the investment portfolio of the Company; (iii) that the aforementioned calculations have been done appropriately by recalculating the applicable interest income accretion or amortization of cost basis for a sample of each category of RMBS; and (iv) review portfolio reports provided by its third party vendor in order to identify exceptions and inconsistencies. The Company believes that the new procedures, will remediate the material weakness described above, subject to the successful implementation and testing of the operating effectiveness of the implemented controls. However, the Company cannot provide any assurance that these remediation efforts will be successful or that its internal control over financial reporting will be effective as a result of these efforts.

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**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

From time to time, the Company may be involved in various claims and legal actions arising in the ordinary course of business. As of June 30, 2013, the Company was not involved in any legal proceedings.

**ITEM 1A. Risk Factors**

Other than the risk factor set forth below, there were no material changes during the period covered by this report to the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2012, as filed with the SEC on April 9, 2013. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse effect on our business, financial condition and results of operation.

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

When we engage in repurchase transactions, we generally sell securities to lenders (repurchase agreement counterparties) and receive cash from these lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender will be less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us we may incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the securities). We would also lose money on a repurchase transaction if the value of the underlying securities has declined as of the end of the transaction term, as we would have to repurchase the securities for their initial value but would receive securities worth less than that amount. Further, if we default on one of our obligations under a repurchase transaction, the lender can terminate the transaction and cease entering into any other repurchase transactions with us. Our repurchase agreements contain cross-default provisions, such that if a default occurs under an agreement with any specific lender, that lender could also declare a default under other repurchase agreements or other financing or derivative contracts, if any, with such lender. Further, each of the counterparties to our repurchase agreements hold collateral valued in excess of 5% of our stockholders' equity as security for our obligations under the applicable repurchase agreements. Any losses we incur on our repurchase transactions could adversely affect our earnings and thus our cash available for distribution to our stockholders.

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

None.

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Mine Safety Disclosures**

Not Applicable.

**ITEM 5. Other Information**

None.

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**ITEM 6. Exhibits**

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

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

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101.CAL\*\* XBRL Taxonomy Extension Calculation Linkbase Document  
101.DEF\*\* XBRL Taxonomy Extension Definition Linkbase Document  
101.LAB\*\* XBRL Taxonomy Extension Label Linkbase Document  
101.PRE\*\* XBRL Taxonomy Extension Presentation Linkbase Document

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\*Fully or partly previously filed.

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

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WESTERN ASSET MORTGAGE CAPITAL CORPORATION

August 13, 2013

By: */s/ GAVIN L. JAMES*

**Gavin L. James**  
**President, Chief Executive Officer and Director**

By: */s/ STEVEN M. SHERWYN*

**Steven M. Sherwyn**  
**Chief Financial Officer and Treasurer**