CAPSTEAD MORTGAGE CORP
Form 10-K
February 27, 2015

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

FORM 10-K

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

For the fiscal year ended: December 31, 2014

OR

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

For the transition period from ____________ to ______________

Commission File Number: 001-08896

CAPSTEAD MORTGAGE CORPORATION
(Exact name of Registrant as specified in its Charter)

Maryland	75 2027937
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

8401 North Central Expressway, Suite 800, Dallas, TX	75225-4404
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (214) 874-2323

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

Title of Each Class	Name of Exchange on Which Registered
Common Stock ($0.01 par value)	New York Stock Exchange
$7.50% Series E Cumulative Redeemable Preferred Stock ($0.10 par value)	New York Stock Exchange

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO
Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES NO
Indicate by check mark whether the Registrant (1) has filed all documents and reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, 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 during the preceding 12 months (or for such shorter period that Registrant was required to submit and post such files).
YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K:
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer   Accelerated filer   Non-accelerated filer   Smaller reporting company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). YES   NO

At June 30, 2014 the aggregate market value of the common stock held by nonaffiliates was $1,238,555,013.

Number of shares of Common Stock outstanding at February 27, 2015:   95,812,050

DOCUMENTS INCORPORATED BY REFERENCE:
Portions of the Registrant's definitive Proxy Statement, to be issued in connection with the 2015 Annual Meeting of Stockholders of the Registrant, are incorporated by reference into Part III.

CAPSTEAD MORTGAGE CORPORATION
2014 FORM 10-K ANNUAL REPORT
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PART I

ITEM 1. BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a "REIT") and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as "Capstead" or the "Company." Capstead was incorporated in the state of Maryland in 1985 and its common and preferred stocks are listed on the New York Stock Exchange under the symbols "CMO" and "CMOPRE," respectively.

Capstead's investment strategy involves managing an appropriately leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of relatively short-duration adjustable-rate mortgage ("ARM") securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the "GSEs"), or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae, referred to as "Agency Securities," are considered to have limited, if any, credit risk because of federal government support for the GSEs. This strategy differentiates Capstead from its peers because ARM loans underlying its investment portfolio can reset to more current interest rates within a relatively short period of time. This positions the Company to benefit from a potential recovery in financing spreads that typically contract during periods of rising interest rates and can result in smaller fluctuations in portfolio values compared to portfolios containing a significant amount of longer-duration ARM and fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk.

For further discussion of the Company's business and financial condition, see Item 7 of this report, "Management's Discussion and Analysis of Financial Condition and Results of Operations," which is incorporated herein by reference.

Competition

As a residential mortgage REIT that focuses on investing in ARM Agency Securities, Capstead competes for the acquisition of suitable investments with other mortgage REITs, commercial banks, savings banks, insurance companies, and institutional investors such as private equity funds, mutual funds, pension funds and sovereign wealth funds. Many of these entities have lower yield requirements as well as greater financial resources and access to capital than the Company. Increased competition for the acquisition of ARM Agency Securities can result in higher pricing levels for such assets. In addition, the availability of ARM Agency Securities for purchase in the secondary markets varies substantially with changes in market conditions. Although higher pricing levels generally correspond to a higher book value per common share for the Company, higher prices paid for acquisitions can adversely affect portfolio yields and future profitability.

In addition, the federal government, through the Federal Reserve and the GSEs, has accumulated substantial holdings of primarily fixed-rate Agency Securities, largely in order to provide stimulus to the economy through what has been referred to as quantitative easing programs. These programs have had the effect of supporting higher pricing for the entire Agency Securities market, including pricing for ARM Agency Securities. While the Federal Reserve ceased adding to its holdings of fixed-rate Agency Securities late in 2014, it continues to provide economic stimulus by replacing portfolio runoff through open market purchases. The Federal Reserve has indicated that it intends to cease replacing portfolio runoff after it begins to raise short-term interest rates. This action, or a more dramatic reduction in government holdings of fixed-rate Agency Securities in the future, could result in lower pricing levels for Agency Securities, adversely affecting the Company's book value per common share.

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Regulation and Related Matters

Operating as a REIT investing in Agency Securities subjects Capstead to various federal tax and regulatory requirements. For further discussion, see Item 7 of this report, "Management's Discussion and Analysis of Financial Condition and Results of Operations," on pages 28 through 32 under the captions "Risks Related to Capstead's Status as a REIT and Other Tax Matters" and "Risk Factors Related to Capstead's Corporate Structure," which is incorporated herein by reference.

Employees

As of December 31, 2014, Capstead had 13 full-time employees and one part-time employee.

Website Access to Company Reports and Other Company Information

Capstead makes available on its website at www.capstead.com, free of charge, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, investor presentations and press releases, including any amendments to such documents as soon as reasonably practicable after such materials are electronically filed or furnished to the Securities and Exchange Commission ("SEC") or otherwise publicly released.

The SEC maintains an Internet site (www.sec.gov) through which investors may view materials filed with the SEC. Investors may also read and copy any materials filed with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

The Company makes available on its website charters for the committees of its board of directors, its Board of Directors' Guidelines, its Amended and Restated Bylaws, its Code of Business Conduct and Ethics, its Financial Code of Professional Conduct and other information, including amendments to such documents and waivers, if any, to the codes. Such information will also be furnished, free of charge, upon written request to Capstead Mortgage Corporation, Attention: Stockholder Relations, 8401 North Central Expressway, Suite 800, Dallas, Texas 75225-4404.

Cautionary Statement Concerning Forward-Looking Statements

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

- changes in general economic conditions;
- fluctuations in interest rates and levels of mortgage prepayments;
- the effectiveness of risk management strategies;
- the impact of differing levels of leverage employed;
- liquidity of secondary markets and credit markets;
- the availability of financing at reasonable levels and terms to support investing on a leveraged basis;
- the availability of new investment capital;
- the availability of suitable qualifying investments from both an investment return and regulatory perspective;
- changes in legislation or regulation affecting the GSEs, Ginnie Mae and similar federal government agencies and related guarantees;

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- other changes in legislation or regulation affecting the mortgage and banking industries;
- changes in market conditions as a result of Federal Reserve monetary policy or federal government fiscal challenges;
- deterioration in credit quality and ratings of existing or future issuances of GSE or Ginnie Mae securities;
- changes in legislation or regulation affecting exemptions for mortgage REITs from regulation under the Investment Company Act of 1940; and
- increases in costs and other general competitive factors.

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. Forward-looking statements speak only as of the date the statement is made and the Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.

ITEM 1A. RISK FACTORS

Under the captions “Risk Factors” and “Critical Accounting Policies” on pages 23 through 32 and 32 through 33, respectively, of Item 7 are discussions of risk factors and critical accounting policies affecting Capstead’s financial condition and results of operations that are an integral part of this report. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company while reading this document.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Capstead’s headquarters are located in Dallas, Texas in office space leased by the Company.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. MINING SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The New York Stock Exchange trading symbol for Capstead’s common stock is CMO. As of December 31, 2014, the Company had 1,201 common stockholders of record and depository companies held shares of common stock for 49,462 beneficial owners.

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The high and low sales prices and dividends declared on Capstead's common stock were as follows:

	Year ended December 31, 2014			Year ended December 31, 2013		
	Sales Prices		Dividends	Sales Prices		Dividends
	High	Low	Declared	High	Low	Declared
First quarter	$13.15	$11.97	$ 0.34	$13.22	$11.62	$ 0.31
Second quarter	13.43	12.52	0.34	13.28	11.67	0.31
Third quarter	13.32	12.20	0.34	12.52	11.08	0.31
Fourth quarter	13.14	12.24	0.34	12.54	11.25	0.31

Set forth below is a graph comparing the yearly percentage change in the cumulative total return on Capstead's common stock, with the cumulative total return of the Russell 2000 Index and the NAREIT Mortgage REIT Index for the five years ended December 31, 2014 assuming the investment of $100 on December 31, 2009 and the reinvestment of dividends. The stock price and dividend performance reflected in the graph is not necessarily indicative of future performance.

	Year ended December 31					
	2009	2010	2011	2012	2013	2014
Capstead Mortgage Corporation	$100.00	$104.61	$118.65	$122.51	$142.66	$161.21
Russell 2000 Index	100.00	126.86	121.56	141.43	196.34	205.95
NAREIT Mortgage REIT Index	100.00	122.60	119.63	143.43	140.62	165.76

See Item 11 of this report for information regarding equity compensation plans which is incorporated herein by reference. Capstead did not issue any unregistered securities during the past three fiscal years.

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ITEM 6. SELECTED FINANCIAL DATA

This table summarizes selected financial information, including key operating data (in thousands, except percentages, ratios and per share data). For additional information, refer to the audited consolidated financial statements and notes thereto included under Item 8 and "Management's Discussion and Analysis of Financial Condition and Results of Operations," included under Item 7 of this report.

	As of or for the year ended December 31				
	2014	2013	2012	2011	2010
Selected statement of income data:					
Interest income on residential mortgage investments (before investment premium amortization)	$328,621	$341,009	$352,608	$311,154	$256,069
Investment premium amortization	(101,872)	(125,872)	(96,677)	(68,077)	(57,581)
Related interest expense	(65,155)	(66,368)	(69,101)	(57,328)	(47,502)
	161,594	148,769	186,830	185,749	150,986
Other interest income (expense) [(a)]	(8,173)	(8,165)	(7,790)	(8,192)	(7,200)
	153,421	140,604	179,040	177,557	143,786
Other revenue (expense)	(12,601)	(14,117)	(15,414)	(17,353)	(16,890)
Net income	$140,820	$126,487	$163,626	$160,204	$126,896
Net income per diluted common share [(b)]	$1.33	$0.93	$1.50	$1.75	$1.52
Cash dividends per share of common stock	1.36	1.24	1.49	1.76	1.51
Average diluted common stock outstanding	95,629	95,393	95,012	79,696	69,901
Selected balance sheet data:					
Residential mortgage investments	$13,908,104	$13,475,874	$13,860,158	$12,264,906	$8,515,691
Total assets	14,389,069	14,015,968	14,469,263	12,844,622	8,999,362
Repurchase arrangements and similar borrowings	12,806,843	12,482,900	12,784,238	11,352,444	7,792,743
Long-term investment capital ("LTIC"):					
Unsecured borrowings (net of related investments in statutory trusts prior to dissolution in December 2013)	100,000	100,000	99,978	99,978	99,978
Preferred stockholders' equity	183,936	165,756	188,992	184,514	179,323
Common stockholders' equity	1,206,835	1,200,027	1,308,133	1,108,193	848,102
Book value per common share (unaudited)	12.52	12.47	13.58	12.52	12.02
Key operating data: (unaudited)					
Portfolio acquisitions (principal amount)	$3,191,256	$3,187,534	$4,206,459	$5,673,803	$3,299,600
Portfolio runoff (principal amount)	2,801,144	3,483,756	2,784,687	2,127,812	2,932,978
Common equity capital raised	–	–	142,036	231,673	10,423
Common stock repurchases	–	7,292	35,062	–	–
Year-end portfolio leverage ratio [(c)]	8.59:1	8.52:1	8.00:1	8.15:1	6.91:1
Average financing spreads on residentialmortgage investments [(d)]	1.17 %	1.07 %	1.38 %	1.68 %	1.93 %
Average total financing spreads [(d)]	1.06	0.96	1.26	1.56	1.74
	17.28	21.45	17.60	16.58	29.47

Average mortgage prepayment rates, (expressed as constant prepayment rates, or CPRs)					
Return on average LTIC	9.95	8.72	10.98	13.14	12.08
Return on average common equity capital	10.37	7.08	11.15	13.94	12.68

(a) Consists principally of interest on unsecured borrowings and is presented net of earnings of related statutory trusts prior to dissolution in December 2013.

(b) Net income per diluted common share in 2013 includes reductions in net income available to common stockholders totaling $0.23 related to convertible preferred stock redemption preference premiums paid and dividends accruing on then-outstanding shares of convertible preferred stock from the May 2013 issue date of the Company's Series E preferred stock through the June 2013 redemption of the convertible preferred stock. See Item 7 pages 8 and 14 for further discussion.

(c) Year-end portfolio leverage ratios were calculated by dividing repurchase arrangements and similar borrowings by long-term investment capital.

(d) Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on Capstead's residential mortgage investments, net of borrowing rates on repurchase arrangements and similar borrowings, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See Item 7 page 14 for reconciliations of these measures and the Company's rationale for using this non-GAAP financial measure.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Capstead operates as a self-managed REIT and earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of short-duration ARM Agency Securities, which are considered to have limited, if any, credit risk and reset to more current interest rates within a relatively short period of time. Capstead's strategy of investing in ARM Agency Securities positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates and experience smaller fluctuations in portfolio values compared to leveraged portfolios containing a significant amount of longer-duration ARM or fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk.

Capstead finances its portfolio of ARM Agency Securities with borrowings under repurchase arrangements with commercial banks and other financial institutions (referred to as "repo" borrowings) supported by its long-term investment capital. As of December 31, 2014, long-term investment capital totaled $1.49 billion and consisted of $1.21 billion of common and $184 million of perpetual preferred stockholders' equity (recorded amounts) and $100 million of unsecured borrowings that mature in 2035 and 2036. Long-term investment capital increased by $25 million during 2014 primarily as a result of higher portfolio pricing levels and Series E preferred capital raised using an at-the-market continuous offering program, partially offset by lower pricing levels for interest rate swap agreements held for hedging purposes and dividend distributions in excess of earnings.

Capstead's holdings of residential mortgage investments increased by $432 million during 2014 to $13.91 billion, with portfolio acquisitions exceeding portfolio runoff by $390 million (principal amount) and the remainder primarily attributable to an increase in overall portfolio pricing levels. Repo borrowings increased by $324 million during 2014 to $12.81 billion. Portfolio leverage (repo borrowings divided by long-term investment capital) increased to 8.59 to one at December 31, 2014 from 8.52 to one at December 31, 2013. Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

Capstead's net income totaled $141 million or $1.33 per diluted common share for the year ended December 31, 2014, compared to $126 million or $0.93 per diluted common share in 2013. Net income per diluted common share for 2013 includes reductions in net income available to common stockholders totaling $0.23 per diluted common share pertaining to redemption preference premiums paid and other effects of second quarter 2013 preferred capital transactions. See pages 8 and 14 for further information.

Earnings were higher in 2014 reflecting improved net interest margins primarily as a result of $24 million in lower investment premium amortization reflecting lower mortgage prepayment rates, partially offset by lower cash yields on the portfolio and slightly lower borrowing costs. Lower mortgage prepayment rates reflected higher prevailing mortgage interest rates during 2014 compared to rates that were available during the first half of 2013, which has made it less economically advantageous for borrowers to refinance. Cash yields declined because of the effects of ARM loan coupon interest rates resetting lower to more current rates as well as lower coupon interest rates on acquisitions. Lower short-term incentive compensation costs also contributed to higher earnings in 2014.

Financing spreads on residential mortgage investments averaged 1.17% during 2014, compared to 1.07% during 2013. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on residential mortgage investments, net of repo borrowing rates, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets,as well as rates paid on all interest-bearing liabilities,

principally unsecured borrowings. See page 14 for a reconciliation of these GAAP and non-GAAP financial measures. Yields on residential mortgage investments improved ten basis points to average 1.69% during 2014, reflecting 17 basis points in lower yield adjustments for investment premium amortization offset by seven basis points in lower cash yields. Repo borrowing rates, adjusted for currently-paying interest rate swap agreements held for hedging purposes, were lower by less than one basis point, averaging 0.52% during 2014.

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Capstead remains a leader among its mortgage REIT peers in terms of operating efficiency. Operating costs (salaries and benefits, incentive compensation and other general and administrative expense) expressed as an annualized percentage of long-term investment capital averaged 0.83% for 2014, six basis points lower than in 2013, primarily reflecting lower short-term incentive compensation costs.

The size and composition of Capstead's investment portfolio depends on investment strategies being implemented by management, as well as overall market conditions, including the availability of attractively priced investments and suitable financing to leverage the Company's investment capital. Market conditions are influenced by, among other things, current and future expectations for short-term interest rates, mortgage prepayments and market liquidity.

Risk Factors and Critical Accounting Policies

Under the captions "Risk Factors" and "Critical Accounting Policies" are discussions of risk factors and critical accounting policies affecting Capstead's financial condition and earnings that are an integral part of this discussion and analysis. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company and its financial results.

Capital Transactions

In 2013 Capstead redeemed its then-outstanding convertible preferred stock using $164 million in net proceeds from a public offering of 6.8 million shares ($170 million face amount) of its 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference $25.00 per share, together with $43 million of cash on hand. The convertible preferred stock that was redeemed had redemption preferences aggregating $207 million, a total of approximately $20 million in excess of these shares' recorded amounts on the balance sheet. This redemption preference premium is reflected as a reduction in net income available to common stockholders for the year ended December 31, 2013.

In late 2013 the Company began issuing additional shares of Series E preferred stock through an at-the-market continuous offering program. During the year ended December 31, 2014, the Company issued 757,000 shares of Series E preferred stock at an average price of $24.01, net of expenses, for net proceeds of $18 million under this program. Another 222,000 shares of Series E preferred stock were issued subsequent to year-end through February 27, 2015 at an average price of $24.65, net of expenses, for net proceeds of $5 million.

Additional amounts of Series E preferred capital and new common equity capital may be raised in the future under continuous offering programs or by other means, subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

Book Value per Common Share

Nearly all of Capstead's residential mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company's balance sheet and are therefore included in the calculation of book value per common share (total stockholders' equity, less liquidation preferences for outstanding shares of preferred stock, divided by outstanding shares of common stock). Fair value is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels, among other factors. The Company's investment strategy attempts to mitigate these risks by focusing on investments in Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans with interest rates that reset periodically to more current levels generally within five years. Because of these characteristics, the fair value of the Company's portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to leveraged portfolios containing a significant amount of non-agency securities or longer-duration ARM and/or fixed-rate Agency Securities.

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The following table illustrates the progression of Capstead's book value per common share as well as changes in book value expressed as percentages of beginning book value for the indicated periods:

	As of and for the year ended December 31					
	2014		2013		2012	
Book value per common share, beginning of year	$12.47		$13.58		$12.52	
Change in unrealized gains and losses on mortgage securities classified as available-for-sale	0.28		(1.05)		0.95	
Change in unrealized gains and losses on interest rate swap agreements designated as cash flow hedges of: Repo borrowings	0.06		0.08		(0.04)	
Unsecured borrowings	(0.26)		0.19		0.02	
	0.08	0.6 %	(0.78)	(5.8)%	0.93	7.4 %
One-time effects of second quarter 2013 preferred capital transactions	–		(0.28)		–	
Other capital transactions:						
Dividend distributions in excess of core earnings available to common stockholders*	(0.04)		(0.08)		(0.01)	
(Dilution) accretion from capital raises	(0.01)		–		0.12	
Accretion from common stock repurchases	–		0.01		0.02	
Accretion related to stock awards	0.02		0.02		–	
	(0.03)	(0.2)%	(0.33)	(2.4)%	0.13	1.1 %
Book value per common share, end of year	$12.52		$12.47		$13.58	
Change in book value per common share during the indicated year	$0.05	0.4 %	$(1.11)	(8.2)%	$1.06	8.5 %

* Core earnings available to common stockholders is a non-GAAP financial measure that differs from net income available to common stockholders by excluding $0.23 in redemption preference premiums paid and other effects of the second quarter 2013 preferred capital transactions. See page 14 for a reconciliation of these financial measures and the Company's rationale for using this non-GAAP financial measure.

Residential Mortgage Investments

Capstead's investment strategy focuses on managing a large portfolio of residential mortgage investments consisting almost exclusively of ARM Agency Securities. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by the GSEs, which are federally chartered corporations, or Ginnie Mae, which is an agency of the federal government. Federal government support for the GSEs has largely alleviated market concerns regarding the ability of the GSEs to fulfill their guarantee obligations.

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ARM securities are backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, the coupon interest rates of mortgage loans underlying the Company's ARM securities typically adjust either:

- annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate ("CMT") or the one-year London interbank offered rate ("LIBOR"),
- semiannually based on specified margins over six-month LIBOR, or
- monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index.

These coupon interest rate adjustments are usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

By focusing on investing in short-duration ARM Agency Securities, changes in fair value caused by changes in interest rates are typically relatively modest compared to changes in fair value of investments in longer-duration ARM or fixed-rate assets. Declines in fair value caused by increases in interest rates are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment. This investment strategy positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates.

The following table illustrates the progression of Capstead's portfolio of residential mortgage investments for the indicated periods (dollars in thousands):

	As of and for the year ended December 31		
	2014	2013	2012
Residential mortgage investments, beginning of year	$13,475,874	$13,860,158	$12,264,906
Increase (decrease) in net unrealized gains on securities classified as available-for-sale	27,283	(101,001)	91,750
Portfolio acquisitions (principal amount) at average lifetime purchased yields of 2.44%, 2.28% and 2.17%, respectively	3,191,256	3,187,534	4,206,459
Investment premiums on acquisitions*	116,707	138,811	178,407
Portfolio runoff (principal amount)	(2,801,144)	(3,483,756)	(2,784,687)
Investment premium amortization*	(101,872)	(125,872)	(96,677)
Residential mortgage investments, end of year	$13,908,104	$13,475,874	$13,860,158

* Residential mortgage investments typically are acquired at a premium to the securities' unpaid principal balances. Investment premiums are recognized in earnings as portfolio yield adjustments using the interest method over the estimated lives of the related investments. As such, the level of mortgage prepayments impacts how quickly investment premiums are amortized.

Capstead classifies its ARM securities based on the average length of time until the loans underlying each security reset to more current rates ("months-to-roll") (less than 18 months for "current-reset" ARM securities, and 18 months or greater for "longer-to-reset" ARM securities). After consideration of any applicable initial fixed-rate periods, at December 31, 2014 approximately 86%, 9% and 5% of the Company's ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly, respectively. Approximately 80% of the Company's current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an initial coupon reset date. Additionally, at December 31, 2014 approximately 12% of the Company's ARM securities were backed by interest-only loans, with remaining interest-only payment periods of up to

nine years. All percentages are based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated date. The Company’s ARM holdings featured the following characteristics at December 31, 2014 (dollars in thousands):

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ARM Type	Amortized Cost Basis (a)	Net WAC (b)	Fully Indexed WAC (b)	Average Net Margins (b)	Average Periodic Caps (b)	Average Lifetime Caps (b)	Months To Roll
Current-reset ARMs:							
Fannie Mae Agency Securities	$4,362,189	2.26 %	2.14 %	1.70 %	3.28 %	9.93 %	5.6
Freddie Mac Agency Securities	1,647,969	2.38	2.23	1.82	2.35	10.27	7.0
Ginnie Mae Agency Securities	1,652,852	2.46	1.62	1.51	1.06	8.48	8.1
Residential mortgage loans	3,059	3.38	2.23	2.03	1.57	10.98	4.7
(56% of total)	7,666,069	2.33	2.05	1.69	2.60	9.69	6.4
Longer-to-reset ARMs:							
Fannie Mae Agency Securities	2,607,355	2.78	2.25	1.69	4.42	7.79	38.3
Freddie Mac Agency Securities	1,941,687	2.85	2.30	1.74	3.72	7.92	41.7
Ginnie Mae Agency Securities	1,434,718	2.83	1.62	1.51	1.10	7.91	38.8
(44% of total)	5,983,760	2.82	2.11	1.66	3.40	7.86	39.5
	$13,649,829	2.54	2.08	1.68	2.95	8.89	20.9
Gross WAC (rate paid by borrowers) (c)		3.15					

(a) Amortized cost basis represents the Company’s investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. At December 31, 2014, the ratio of amortized cost basis to unpaid principal balance for the Company’s ARM holdings was 103.27. This table excludes $6 million in fixed-rate Agency Securities, residential mortgage loans and private residential mortgage pass-through securities held as collateral for structured financings.

(b) Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments, net of servicing and other fees as of the indicated date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average net margins represent the weighted average levels over the underlying indexes that the portfolio can adjust to upon reset, usually subject to initial, periodic and/or lifetime caps on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. ARM securities issued by the GSEs with initial fixed-rate periods of five years or longer typically have either 200 or 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities held by the Company are subject only to lifetime caps or are not subject to a cap. For presentation purposes, average periodic caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime caps. At year-end, 69% of current-reset ARMs were subject to periodic caps averaging 1.80%; 20% were subject to initial caps averaging 2.66%; 10% were subject to lifetime caps averaging 7.69%; and 1% were not subject to a cap. All longer-to-reset ARM securities at December 31, 2014 were subject to initial caps.

(c) Gross WAC is the weighted average interest rate of the mortgage loans underlying the indicated investments, including servicing and other fees paid by borrowers, as of the indicated balance sheet date.

Capstead pledges its residential mortgage investments as collateral under repurchase arrangements with commercial banks and other financial institutions, referred to as counterparties, the terms and conditions of which are negotiated on a transaction-by-transaction basis when each such repo borrowing is initiated or renewed. None of the Company’s counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, routinely with terms of 30 to 90 days, and are accounted for as borrowings by the Company. The Company maintains the beneficial interest in the specific

securities pledged during each borrowing's term and receives the related principal and interest payments. The amount borrowed is generally equal to the fair value of the securities pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a "haircut." Haircuts on outstanding repo borrowings averaged 4.5 percent and ranged from 3.0 to 5.0 percent of the fair value of pledged residential mortgage pass-through securities at December 31, 2014, little changed from the prior year. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had $702 million of capital at risk with its lending counterparties at December 31, 2014. The Company did not have capital at risk with any single counterparty exceeding 4.0% at December 31, 2014.

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Repo borrowing rates are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of a repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing haircuts and rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly security pay down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. Conversely, if collateral fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls.

As of December 31, 2014 the Company's repo borrowings totaled $12.81 billion with 27 counterparties at average rates of 0.38%, before the effects of interest rate swap agreements held as cash flow hedges and 0.58% including the effects of these derivatives. To help mitigate exposure to higher short-term interest rates and to secure longer-term, committed financing, Capstead may enter into longer-dated repurchase arrangements if available at attractive rates and terms. To this end, during the third and fourth quarters of 2014 the Company entered into $1.78 billion in 12- to 18-month repo borrowings at average rates of 0.56%.

To further reduce exposure to higher short-term interest rates, the Company uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. Variable payments received by the Company under these swap agreements offset a significant portion of the interest accruing on a like amount of the Company's 30- to 90-day repo borrowings. As a result, the Company's effective borrowing rate for these borrowings consists of fixed-rate payments made on the swap agreements adjusted for differences between variable rate payments received on the swap agreements and related actual repo borrowing rates, as well as the effects of measured hedge ineffectiveness.

At December 31, 2014, the Company held portfolio financing-related swap agreements totaling $7.70 billion notional amount with average contract expirations of 12 months. These swap positions consisted of (a) $7.20 billion notional amount in currently-paying swap agreements requiring the payment of fixed rates of interest averaging 0.51% for average remaining interest-payment terms of 12 months and (b) $500 million notional amount in forward-starting swap agreements that will begin requiring fixed rate interest payments averaging 0.72% for two-year periods commencing in January 2015, with average contract expirations of 24 months.

The Company entered into new forward-starting swap agreements during 2014 with notional amounts totaling $2.30 billion requiring fixed rate interest payments averaging 0.62% for two-year periods commencing on various dates between April 2014 and January 2015. Also during 2014, $1.30 billion notional amount of swaps requiring fixed rate interest payments averaging 0.55% matured, while $4.30 billion notional amount of previously acquired forward-starting swaps requiring fixed rate interest payments averaging 0.54% moved into current-pay status.

After consideration of all portfolio financing-related swap positions entered into as of year-end, the Company's residential mortgage investments and related repo borrowings had estimated durations at December 31, 2014 of 11¼ and 9 months, respectively, for a net duration gap of approximately 2¼ months – see pages 21 and 22 under the caption "Interest Rate Risk" for further information about the Company's sensitivity to changes in market interest rates. The Company intends to continue to manage interest rate risk associated with holding and financing is residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repo borrowings if available at attractive terms.

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Analysis of Quarterly Financing Spreads

Components of quarterly financing spreads on residential mortgage investments, a non-GAAP financial measure, and mortgage prepayment rates, were as follows for the indicated periods:

	2014				2013			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Yields on residential mortgage investments:[(a)]								
Cash yields	2.43 %	2.44 %	2.46 %	2.46 %	2.48 %	2.50 %	2.52 %	2.57 %
Investment premium amortization	(0.77)	(0.84)	(0.75)	(0.67)	(0.74)	(1.14)	(0.99)	(0.84)
Adjusted yields	1.66	1.60	1.71	1.79	1.74	1.36	1.53	1.73
Related borrowing rates:[(b)]								
Repo borrowing rates	0.36	0.32	0.32	0.34	0.38	0.37	0.39	0.41
Fixed swap rates	0.51	0.50	0.49	0.50	0.52	0.59	0.65	0.71
Adjusted borrowing rates	0.56	0.51	0.49	0.49	0.49	0.49	0.53	0.58
Financing spreads on residential mortgage investments[(c)]	1.10	1.09	1.22	1.30	1.25	0.87	1.00	1.15
CPR	17.58	19.18	17.22	15.16	17.14	25.49	23.12	20.05

(a) Cash yields are based on the cash component of interest income. Investment premium amortization is determined using the interest method which incorporates actual and anticipated future mortgage prepayments. Both are expressed as a percentage calculated on an annualized basis on average amortized cost basis for the indicated periods.

(b) Repo borrowing rates represent average rates on repurchase agreements and similar borrowings, before consideration of related currently-paying interest rate swap agreements.

Fixed swap rates represent the average fixed-rate payments made on currently-paying interest rate swap agreements held for portfolio hedging purposes and exclude effects of the spread between LIBOR-based variable-rate payments received on these swaps and designated 30- to 90-day repo borrowing rates, as well as the effects of any hedge ineffectiveness. These effects averaged 18 and 19 basis points on average currently-paying swap notional amounts outstanding during 2014 and 2013, respectively.

Adjusted borrowing rates reflect repo borrowing rates, fixed swap rates and the above-mentioned differences. All rates presented are expressed as a percentage calculated on an annualized basis for the indicated periods.

(c) See page 14 for the Company's rationale for using this non-GAAP financial measure and a reconciliation to its related GAAP financial measure, total financing spreads.

Declines in cash yields have been muted in recent quarters as coupon interest rates on more of the loans underlying the portfolio reset to fully-indexed levels. Investment premium amortization is primarily driven by changes in mortgage prepayment rates and investment premium levels. During the first three quarters of 2013 the Company experienced relatively high levels of mortgage prepayments driven by improving housing markets and the availability of generationally-low mortgage interest rates that made it economically advantageous for mortgagors to refinance. Mortgage prepayment rates began declining in September 2013 and reached a two-year low in the first quarter of 2014 largely because of higher prevailing mortgage interest rates as well as seasonal factors. Average quarterly mortgage prepayment rates increased in both the second and third quarters of 2014 in large part due to seasonal factors. In 2014 mortgage prepayment rates peaked in August at a CPR of 20.05% before beginning to recede in September reflecting the end of the summer selling season. The cost basis of the portfolio (expressed as a ratio of amortized cost basis to

unpaid principal balance) remained fairly stable during 2014, having increased less than 2 basis points during the year to 103.27 at December 31, 2014. By comparison, from the end of 2010 to December 31, 2013 the Company's cost basis increased a total of 123 basis points as older lower-basis securities prepaid and were replaced at higher prices, contributing to higher premium levels and larger yield adjustments for investment premium amortization.

Adjusted for portfolio financing-related and currently-paying interest rate swap agreements, borrowing rates averaged 0.56% during the fourth quarter of 2014, an increase of five basis points from the third quarter of 2014 reflecting a greater use of longer-dated repo borrowings and more portfolio-financing related interest rate swap agreements moving into current-pay status, as well as market pressure on year-end repo borrowing rates. Future borrowing rates will be dependent on market conditions, including the availability of longer-term repo borrowings and interest rate swap agreements at attractive rates. See NOTE 7 to the consolidated financial statements for further information regarding the Company's currently-paying and forward-starting swap agreements.

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Reconciliation of GAAP and non-GAAP Financing Spread Disclosures

Financing spreads on residential mortgage investments differs from total financing spreads, an all-inclusive GAAP measure, that is based on all interest-earning assets and liabilities. Management believes presenting financing spreads on residential mortgage investments provides useful information for evaluating portfolio performance. The following reconciles these measures for the indicated periods:

	2014				2013			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Financing spreads on residential mortgage investments	1.10 %	1.09 %	1.22 %	1.30 %	1.25 %	0.87 %	1.00 %	1.15 %
Impact of lower yields on other interest-earning assets*	(0.05)	(0.04)	(0.05)	(0.04)	(0.03)	(0.02)	(0.05)	(0.05)
Impact of higher borrowing rates on other interest-paying liabilities*	(0.07)	(0.06)	(0.07)	(0.07)	(0.07)	(0.06)	(0.06)	(0.06)
Total financing spreads	0.98	0.99	1.10	1.19	1.15	0.79	0.89	1.04

	2014	2013	2012	2011	2010
Financing spreads on residential mortgage investments	1.17 %	1.07 %	1.38 %	1.68 %	1.93 %
Impact of lower yields on other interest- earning assets*	(0.05)	(0.04)	(0.06)	(0.04)	(0.07)
Impact of higher borrowing rates on other interest-paying liabilities*	(0.06)	(0.07)	(0.06)	(0.08)	(0.12)
Total financing spreads	1.06	0.96	1.26	1.56	1.74

* Other interest-earning assets consist of overnight investments and cash collateral receivable from interest rate swap counterparties. Other interest-paying liabilities consist of $100 million in unsecured borrowings (at an average borrowing rate of 8.49%) that the Company considers a component of its long-term investment capital and, where applicable, cash collateral payable to interest rate swap counterparties.

Reconciliation of Net income Available to Common Stockholders to Core Earnings Available to Common Stockholders and Related Per Share Information

Core earnings available to common stockholders and core earnings per diluted common share are non-GAAP financial measures that differ from the related GAAP measures of net income available to common stockholders and net income per diluted common share by excluding certain effects of the May 2013 initial public offering of the Company’s Series E preferred stock and the June 2013 redemption of then-outstanding convertible preferred stock. Management believes presenting this metric on a core earnings basis provides useful, comparative information for evaluating performance. The following reconciles these measures for the year ended December 31, 2013 (in thousands, except per share amounts):

		Per diluted common share
Net income available to common stockholders	$89,027	$ 0.93
Redemption preference premiums paid	19,924	0.21
Convertible preferred dividends accruing from the Series E preferred stock issue date to the convertible preferred redemption date	1,741	0.02
Core earnings available to common stockholders	$110,692	$ 1.16

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Utilization of Long-term Investment Capital and Potential Liquidity

Capstead's investment strategy involves managing an appropriately leveraged portfolio of ARM Agency Securities that management believes can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. Repo borrowings generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Consequently, potential liquidity inherent in the Company's unencumbered residential mortgage investments is as important as the actual level of cash and cash equivalents carried on the balance sheet. Potential liquidity is affected by, among other things:

- current portfolio leverage levels,
- changes in market value of assets pledged and interest rate swap agreements held for hedging purposes as determined by lending and swap counterparties,
- principal prepayments,
- collateral requirements of lenders and swap counterparties, and
- general conditions in the commercial banking and mortgage finance industries.

Future levels of portfolio leverage will be dependent upon many factors, including the size and composition of the Company's investment portfolio (see "Liquidity and Capital Resources"). The Company's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of December 31, 2014 in comparison with December 31, 2013 (in thousands):

	Investments (a)	Repo Borrowings	Capital Employed	Potential Liquidity (b)	Portfolio Leverage
Balances as of December 31, 2014:					
Residential mortgage investments	$13,908,104	$12,806,843	$1,101,261	$446,049	
Cash collateral receivable from swap counterparties, net (c)			27,762	–	
Other assets, net of other liabilities			361,748	307,526	
			$1,490,771	$753,575	8.59:1
Balances as of December 31, 2013	$13,475,874	$12,482,900	$1,465,783	$770,639	8.52:1

(a) Investments are stated at balance sheet carrying amounts, which generally reflect estimated fair value as of the indicated dates.

(b) Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted repurchase arrangements considering management's estimate of the fair value of related collateral as of the indicated dates adjusted for other sources of liquidity such as cash and cash equivalents.

(c) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties, if applicable, and the fair value of interest rate swap positions as of the indicated date.

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (remitted to the Company 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to

address challenging market conditions and limits exposure to any individual counterparty.

At December 31, 2014 portfolio leverage and potential liquidity were largely unchanged from the prior year-end while the portfolio and long-term investment capital increased modestly. Management believes current portfolio leverage levels represent an appropriate and prudent use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

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Tax Considerations of Dividends Paid on Capstead Common and Preferred Shares

Capstead's common and preferred dividend distributions are generally characterized as ordinary income or non-taxable return of capital based on the relative amounts of the Company's earnings and profits (taxable income, with certain prescribed adjustments) to total distributions applicable for a given tax year. Distributions in excess of earnings and profits, if any, are characterized as non-taxable return of capital, reducing the tax basis of the related shares. If the Company were to realize gains on sales of assets, a portion of its dividends may be characterized as long-term capital gains. Except in limited circumstances, none of the Company's dividends will be considered qualifying dividends eligible to be taxed at a reduced dividend tax rate. All dividends taxable in 2014, 2013 and 2012 have been characterized as ordinary income.

In accordance with the spillover distribution provisions of IRC 857(b)(9), $0.226769 of the fourth quarter 2014 common dividend of $0.34 paid in January 2015 was taxable in 2014 and the remaining $0.113231 is expected to be taxable in 2015. Similarly, $0.214753 of the fourth quarter 2013 common dividend of $0.31 paid in January 2014 was taxable in 2013 and the remaining $0.095247 was taxable in 2014. Dividend characterization for all tax years is available in the investor relations section of the Company's website at www.capstead.com. Due to the complex nature of applicable tax rules, it is recommended that stockholders consult their tax advisors to ensure proper tax treatment of dividends received.

Off-Balance Sheet Arrangements and Contractual Obligations

At December 31, 2014, Capstead did not have any off-balance sheet arrangements. The Company's contractual obligations at December 31, 2014 were as follows (in thousands):

	Payments Due by Period*				
	Total	12 Months or Less	13 – 36 Months	37 – 60 Months	>Than 60 Months
Repo borrowings	$12,824,838	$11,972,335	$852,085	$290	$128
Unsecured borrowings	232,336	8,153	10,894	11,661	201,628
Interest rate swap agreements designated as cash flow hedges of:					
Repo borrowings	16,533	16,533	–	–	–
Unsecured borrowings	25,280	–	4,042	3,195	18,043
Portfolio acquisitions settling subsequent to year-end	39,956	39,956	–	–	–
Corporate office lease	1,597	277	573	597	150
	$13,140,540	$12,037,254	$867,594	$15,743	$219,949

* Repo borrowings include an interest component based on contractual rates in effect at year-end. Obligations under interest rate swap agreements are net of variable-rate payments owed to the Company under the agreements' terms that are based on market interest rate expectations as of year-end.

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RESULTS OF OPERATIONS

	Year ended December 31		
	2014	2013	2012
Income statement data (in thousands, except per share data)			
Interest income on residential mortgage investments (before investment premium amortization)	$328,621	$341,009	$352,608
Investment premium amortization	(101,872)	(125,872)	(96,677)
Related interest expense	(65,155)	(66,368)	(69,101)
	161,594	148,769	186,830
Other interest income (expense)	(8,173)	(8,165)	(7,790)
	153,421	140,604	179,040
Other revenue (expense):			
Salaries and benefits	(4,112)	(3,962)	(4,055)
Short-term incentive compensation	(2,115)	(3,565)	(5,043)
Long-term incentive compensation	(2,075)	(1,814)	(1,874)
Other general and administrative expense	(4,157)	(4,476)	(4,271)
Miscellaneous other revenue (expense)	(142)	(300)	(171)
	(12,601)	(14,117)	(15,414)
Net income	$140,820	$126,487	$163,626
Net income per diluted common share	$1.33	$0.93	$1.50
Average diluted shares outstanding	95,629	95,393	95,012
Key operating statistics (dollars in millions)			
Average yields:			
Residential mortgage investments:			
Cash yields	2.45 %	2.52 %	2.67 %
Investment premium amortization	(0.76)	(0.93)	(0.73)
Adjusted yields	1.69	1.59	1.94
Other interest-earning assets	0.08	0.10	0.16
Total average yields	1.64	1.55	1.88
Average borrowing rates:			
Repo borrowings:			
Repo borrowing rates	0.34	0.39	0.39
Fixed swap rates	0.50	0.62	0.79
Adjusted borrowing rates	0.52	0.52	0.56
Unsecured borrowings	8.49	8.49	8.49
Total average borrowing rates	0.58	0.59	0.62
Average financing spreads on residential mortgage investments, a non-GAAP financial measure [a]	1.17	1.07	1.38
Average total financing spreads	1.06	0.96	1.26
Average net yield on total interest-earning assets	1.11	1.01	1.31
Average CPR	17.28	21.45	17.60
Average balance information:			
Residential mortgage investments (cost basis)	$13,424	$13,551	$13,190
Other interest-earning assets	398	336	446
Repo borrowings	12,651	12,703	12,443
Currently-paying swap agreements (notional amounts)	6,548	3,999	3,794
Unsecured borrowings (included in long-term investment capital)	100	103	103
Long-term investment capital (“LTIC”)	1,500	1,548	1,567
Portfolio leverage	8.43:1	8.21:1	7.94:1

Operating costs as a percentage of average LTIC	0.83 %	0.89 %	0.97 %
Return on average LTIC	9.95	8.72	10.98
Return on average common equity capital	10.37	7.08	11.15

(a) Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on Capstead's residential mortgage investments, net of repo borrowing rates, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 14 for reconciliations of these measures and the Company's rationale for using this non-GAAP financial measure.

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2014 Compared to 2013

Capstead's net income totaled $141 million or $1.33 per diluted common share for the year ended December 31, 2014, compared to $126 million or $0.93 per diluted common share in 2013. Net income per diluted common share for 2013 includes reductions in net income available to common stockholders totaling $0.23 per diluted common share pertaining to redemption preference premiums paid and other effects of second quarter 2013 preferred capital transactions.

Earnings were higher in 2014 reflecting improved net interest margins primarily as a result of lower investment premium amortization reflecting lower mortgage prepayment rates, partially offset by lower cash yields on the portfolio and slightly lower borrowing costs. Lower short-term incentive compensation costs also contributed to higher earnings in 2014.

Financing spreads on residential mortgage investments averaged 1.17% during 2014, compared to 1.07% reported for 2013. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on residential mortgage investments, net of repo borrowing rates, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 14 for a reconciliation of these GAAP and non-GAAP financial measures.

Yields on residential mortgage investments averaged 1.69% during 2014, ten basis points higher than yields reported for 2013. Cash yields averaged 2.45% during 2014, seven basis points lower than in 2013 reflecting the effects of ARM loan coupon interest rates resetting lower to more current rates as well as lower coupon interest rates on acquisitions. The rate of decline in cash yields has slowed over the last two years reflecting more loans underlying the portfolio resetting to fully-indexed levels. The yield adjustment for investment premium amortization averaged 76 basis points during 2014, an improvement of 17 basis points over 2013. Investment premium amortization declined by $24 million, reflecting a 19% decline in mortgage prepayment rates to an average CPR of 17.28% for the year. Lower mortgage prepayment rates reflected higher prevailing mortgage interest rates during 2014 compared to rates that were available during the first half of 2013, which has made it less economically advantageous for borrowers to refinance.

Repo borrowing rates, adjusted for currently-paying interest rate swap agreements held for hedging purposes, were lower by less than one basis point, averaging 0.52% during 2014. Unadjusted repo borrowing rates averaged 0.34% during 2014, five basis points lower than rates reported for 2013. This decline in rates was realized even as the Company took advantage of healthy repo market conditions by securing $1.78 billion in 12- and 18-month repo borrowings at average rates of 0.56% during the latter half of 2014. The benefits to adjusted borrowing rates from lower repo borrowing rates were largely negated by a greater percentage of swap agreements moving into current-pay status, even as average fixed swap rates declined from rates in effect during the prior year with the expiration of older, higher-rate swaps. Currently-paying swap balances averaged $6.55 billion during 2014, compared to $4.00 billion for 2013. Fixed swap rates exclude differences between LIBOR-based variable-rate payments received on these swaps and designated 30- to 90-day repo borrowing rates, as well as the effects of any hedge ineffectiveness. These differences averaged 18 and 19 basis points on average currently-paying swap notional amounts outstanding during 2014 and 2013, respectively. Future repo borrowing rates will be dependent on market conditions, including overall levels of market interest rates as well as the availability of longer-term repo borrowings and interest rate swap agreements at attractive rates.

Operating costs as a percentage of long-term investment capital averaged 0.83% for 2014, six basis points lower than reported for 2013, primarily reflecting lower short-term incentive compensation costs. See NOTE 12 to the accompanying consolidated financial statements (included in Item 8 of this report) for additional information

regarding the Company’s compensation programs.

2013 Compared to 2012

Capstead's net income totaled $126 million or $0.93 per diluted common share for the year ended December 31, 2013, compared to $164 million or $1.50 per diluted common share for 2012. Net income per diluted common share for the year ended December 31, 2013 includes reductions in net income available to common stockholders totaling $0.23 per diluted common share pertaining to redemption preference premiums paid and other one-time effects of second quarter 2013 preferred capital transactions.

Financing spreads on residential mortgage investments averaged 1.07% during 2013, compared to 1.38% reported for 2012. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on the Company's residential mortgage investments, net of borrowing rates on repurchase arrangements and similar borrowings, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 14 for a reconciliation of these GAAP and non-GAAP financial measures.

Lower financing spreads reflect (a) lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates resetting lower to more current rates as well as lower coupon interest rates on acquisitions, and (b) higher investment premium amortization because of higher levels of mortgage prepayments as well as higher prices paid for portfolio acquisitions in recent years. Borrowing rates were modestly lower as older, higher rate interest rate swap agreements used for hedging purposes were replaced at lower rates. Although unchanged year over year at 39 basis points, unhedged repo borrowing rates declined from levels experienced the latter half of 2012 in response to improving market conditions for short-term borrowings.

Yields on residential mortgage securities averaged 1.59% during 2013, which was 35 basis points lower than yields reported for 2012. Cash yields averaged 2.52% during 2013, which was 15 basis points lower than cash yields reported for 2012. Investment premium amortization totaled $126 million for 2013, representing yield adjustments of 93 basis points, compared to amortization of $97 million or 73 basis points for 2012. Approximately 83% of the increase in investment premium amortization is attributable to higher levels of mortgage prepayments due largely to relatively low mortgage interest rates available through early May of 2013. The remaining increase is primarily attributable to increases in the cost basis of the portfolio.

Repo borrowing rates, adjusted for interest rate hedging transactions, averaged 0.52% during 2013, a decrease of four basis points from 2012. Before adjusting for the effects of interest rate swap agreements held as cash flow hedges, repo borrowings rates averaged 0.39% during 2013, largely unchanged from rates reported for 2012. Market rates for repo borrowings increased throughout 2012 while trending lower during 2013 due to changes in market conditions, including less competition for borrowings as a result of significant declines in portfolio holdings experienced by the Company's mortgage REIT peers. Rates on $4.00 billion of the Company's average repo borrowings during 2013 were largely fixed through the use of interest rate swap agreements. The corresponding amount was $3.79 billion for 2012. Fixed-rate payment requirements on the Company's currently-paying swap positions, before certain adjustments including changes in spreads between variable rates on the swap agreements and related actual borrowings and the effects of measured hedge ineffectiveness, averaged 0.62% for 2013, which was 17 basis points lower than rates reported for 2012, reflecting the expiration of older, higher-rate swaps that were replaced at lower rates.

Operating costs as a percentage of long-term investment capital averaged 0.89% during 2013, eight basis points lower than reported for 2012. The decline is largely attributable to lower accruals under the Company's incentive compensation programs, which were substantially revised during 2013.

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LIQUIDITY AND CAPITAL RESOURCES

Capstead's primary sources of funds are repo borrowings and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down repo borrowings to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity inherent in its unencumbered residential mortgage investments is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under "Utilization of Long-term Investment Capital and Potential Liquidity" on page 15 illustrates management's estimate of additional funds potentially available to the Company as of December 31, 2014 and the accompanying discussion provides insight into the Company's perspective on the appropriate level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for the Company's continued qualification as a REIT.

Capstead pledges its residential mortgage investments as collateral under repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each such repo borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. As of December 31, 2014, the Company had uncommitted repurchase facilities with a variety of lending counterparties to finance its portfolio, subject to certain conditions, and had borrowings outstanding with 27 of these counterparties. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Repo borrowings totaled $12.81 billion at December 31, 2014, with $11.03 billion maturing within 90 days. Repo borrowings began the year at $12.48 billion and averaged $12.65 billion during the year. Average repo borrowings during the year can differ from year-end balances for a number of reasons including portfolio growth or contraction as well as differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to higher short-term interest rates and to secure longer-term, committed financing, Capstead may enter into longer-dated repurchase arrangements if available at attractive rates and terms. To this end, during the latter half of 2014 the Company entered into $1.78 billion in 12- to 18-month repo borrowings. To further reduce exposure to higher short-term interest rates, the Company uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. These derivative financial instruments are designated as cash flow hedges of a like amount of repo borrowings. At December 31 2014, portfolio financing-related swap agreements totaling $7.70 billion notional amount with average contract expirations of 12 months, consisting of (a) $7.20 billion notional amount in currently-paying swap agreements requiring the payment of fixed rates of interest averaging 0.51% for average remaining interest-payment terms of 12 months and (b) $500 million notional amount in forward-starting swap agreements that will begin requiring fixed rate interest payments averaging 0.72% for two-year periods commencing in January 2015, with average contract expirations of 24 months.

Relative to the floating rate terms of the Company's $100 million in unsecured borrowings that begin at various dates between October 2015 and September 2016, the Company entered into forward-starting swap agreements to effectively lock in fixed rates of interest that will average 7.56% beginning in September 2016 through maturity in 2035 and 2036. The Company intends to continue to utilize suitable derivative financial instruments such as interest rate swap agreements to manage interest rate risk.

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In late 2013 the Company began issuing shares of its 7.50% Series E Cumulative Redeemable Preferred Stock through an at-the-market continuous offering program. During 2014, the Company raised $18 million in new preferred equity capital under this program. Subsequent to year-end through February 27, 2015 an additional $5 million in new preferred equity capital was raised under the program.

Additional amounts of Series E preferred capital and new common equity capital may be raised in the future under continuous offering programs or by other means, subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

Interest Rate Risk

Because Capstead's residential mortgage investments consist almost entirely of Agency Securities, which are considered to have limited, if any, credit risk, interest rate risk is the primary market risk faced by the Company. Interest rate risk is highly sensitive to a number of factors, including economic conditions, government fiscal policy, central bank monetary policy and banking regulation. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration ARM or fixed-rate assets. These declines can be recovered in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment. This strategy also positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates.

To further reduce exposure to higher short-term interest rates, the Company uses longer-dated repo borrowings, if available at attractive rates and terms, as well as currently-paying and forward-starting interest rate swap agreements that typically require interest payments for two-year terms. These transactions lengthen the effective duration of the Company's borrowings to more closely match the duration of its investments. After consideration of all swap positions entered into as of year-end to hedge changes in short-term interest rates, the Company's residential mortgage investments and related repo borrowings had estimated durations at December 31, 2014 of 11¼ and 9 months, respectively, for a net duration gap of approximately 2¼ months. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repo borrowings if available at attractive terms.

Capstead performs sensitivity analyses using a model to estimate the effects that specific interest rate changes can reasonably be expected to have on net interest margins and portfolio values. All investments, related repo borrowings and derivative financial instruments held are included in these analyses. For net interest margin modeling purposes, the model incorporates management's assumptions for mortgage prepayment levels for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums and reinvesting portfolio runoff. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity. For portfolio valuation modeling purposes, a static portfolio is assumed.

This modeling is the primary tool used by management to assess the direction and magnitude of changes in net interest margins and portfolio values resulting solely from changes in interest rates. Key modeling assumptions include mortgage prepayment speeds, adequate levels of market liquidity, current market conditions, and portfolio leverage levels. Given the present low level of interest rates, a floor of 0.00% is assumed. However, it is assumed that borrowing rates cannot decline beyond a certain level. These assumptions are inherently uncertain and, as a result, modeling cannot precisely estimate the impact of higher or lower interest rates. Actual results will differ from simulated results due to the timing, magnitude and frequency of interest rate changes, other changes in market conditions, changes in management strategies and other factors.

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The table below reflects the estimated impact of instantaneous parallel shifts in the yield curve on net interest margins and the fair value of Capstead's portfolio of residential mortgage investments and related repo borrowings and derivative financial instruments at December 31, 2014 and December 31, 2013, subject to the modeling parameters described above.

	Federal Funds Rate	10-year U.S. Treasury Rate	Down 0.50%	Up 0.50%	Up 1.00%
Projected 12-month percentage change in net interest margins: *					
December 31, 2014	<0.25 %	2.17 %	(21.5)%	7.1 %	9.5 %
December 31, 2013	<0.25	3.03	(15.9)	(1.5)	(6.6)
Projected percentage change in portfolio and related derivative values: *					
December 31, 2014	<0.25	2.17	0.1	(0.2)	(0.3)
December 31, 2013	<0.25	3.03	–	(0.2)	(0.3)

* Sensitivity of net interest margins as well as portfolio and related repo borrowings and derivative values to changes in interest rates is determined relative to the actual rates at the applicable date. Note that the projected 12-month net interest margin change is predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices, if investments made will behave in the same fashion as assets currently held or if management will choose to replace runoff with such assets.

The projected 12-month percentage changes in net interest margins were more pronounced at December 31, 2014 compared to the prior year-end primarily reflecting greater use of currently-paying interest rate swap agreements and longer-dated repo borrowings. As a result, the Company's net interest margins are projected to decline more over the ensuing 12 months in the Down 0.50% scenario than projected the prior year-end because more of its borrowing costs are fixed and therefore will not benefit from lower repo borrowing rates. Conversely, the Company is projected to benefit more from having a greater amount of its borrowing costs fixed over the ensuing 12 months in the Up 0.50% and Up 1.00% scenarios than projected the prior year-end.

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RISK FACTORS

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

Risks Related to Capstead's Business

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

Under the last QE initiative that began in 2012 (referred to as QE3), the Federal Reserve purchased $45 billion a month in long-term Treasury securities and $40 billion a month in fixed-rate Agency Securities, as well as replaced run off of existing holdings of fixed-rate Agency Securities. In January 2014 the Federal Reserve began reducing purchases of Treasuries and Agency Securities and ceased buying additional Treasury and Agency Securities in November 2014, while continuing to replace portfolio runoff. The Federal Reserve has indicated that it will continue replacing portfolio runoff until after it begins raising short-term interest rates.

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

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

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

market stability and mortgage availability at favorable rates in part by providing additional confidence to investors in Agency Securities.

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

Failure of the federal government to reduce future annual federal budget deficits could adversely impact Capstead's liquidity, financial condition and earnings. The increasing amount of outstanding federal debt relative to the size of the U.S. economy, particularly in light of projected growth in federal government spending and resulting federal budget deficits, could eventually lead to a decline in the market's perception of the creditworthiness of the federal government. Because market participants rely on the federal government's continued support of the GSEs, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings of Agency Securities could be adversely affected. In addition, political discord over the U.S. fiscal policy could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of repo borrowings which could adversely impact the Company's liquidity, earnings and book value per common share, as more fully described below.

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

An increase in prepayments may adversely affect Capstead's liquidity, financial condition and earnings. When short- and long-term interest rates are at nearly the same levels (i.e., a "flat yield curve" environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases due to the availability of lower mortgage interest rates to homeowners. Mortgage interest rates and the general availability of mortgage credit can also be impacted by regulatory changes in Agency guarantee fees, loan level pricing adjustments, down payment requirements, as well as other underwriting requirements. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's portfolio of residential mortgage investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums, which could adversely affect earnings. High levels of mortgage prepayments can also lead to larger than anticipated demands on the Company's liquidity from its lending counterparties, as more fully described below. Additionally, periods of high prepayments can adversely affect pricing for Agency Securities in general and, as a result, book value per common share can be adversely affected due to declines in the fair value of the Company's remaining portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

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Changes in interest rates, whether increases or decreases, may adversely affect Capstead's liquidity, financial condition and earnings. Capstead's earnings depend primarily on the difference between the interest received on its residential mortgage investments and the interest paid on its related borrowings, net of the effect of derivatives held for hedging purposes. The Company finances its investments primarily at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on related borrowings not effectively fixed through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more extreme circumstances, negative financing spreads and, therefore, adversely affect earnings. Because rising interest rates tend to put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods adversely affecting the Company's liquidity. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining repo borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

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

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

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

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

Capstead’s use of repo borrowings to finance its investments may expose the Company to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to the Company. Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a simultaneous agreement to repurchase the transferred assets at a future date. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to the Company and subject the Company to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

Capstead’s use of repo borrowings to finance its investments may give the Company’s lending counterparties greater rights if the Company seeks bankruptcy protection, exposing the Company to losses. Repo borrowings may qualify for special treatment under the U.S. Bankruptcy Code. If the Company files for bankruptcy, its lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses to the extent of any margin amounts held by the lending counterparties.

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Capstead may sell assets for various reasons, including a change in the Company’s investment focus, which could increase earnings volatility. Capstead may periodically sell assets to enhance its liquidity during periods of market illiquidity or rising interest rates or the Company may change its investment focus requiring it to sell some portion of its existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-dated repo borrowings or interest rate swap agreements, could increase the Company’s earnings volatility.

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

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

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

Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects. As a self-managed REIT with 13 full-time employees and one part-time employee, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. Although the Company's named executive officers and some of its other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any

of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

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Risks Related to Capstead's Status as a REIT and Other Tax Matters

If Capstead does not qualify as a REIT, the Company will be subject to tax as a regular corporation and face substantial tax liability. Capstead has elected to be taxed as a REIT for federal income tax purposes and intends to continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize the Company's REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for the Company to qualify as a REIT.

If Capstead fails to qualify as a REIT in any tax year, then:

- The Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates;
- Any resulting tax liability could be substantial and would reduce the cash available for distribution to stockholders, and the Company would not be required to make income distributions; and
- Unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years and, as a result, the Company's cash available for distribution to stockholders would be reduced during these years.

Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings. Even if Capstead remains qualified for taxation as a REIT, the Company may be subject to certain federal, state and local taxes on its income and assets. For example, the Company:

- will be required to pay tax on any undistributed REIT taxable income,
- may be subject to the "alternative minimum tax" on any tax preference items, and
- may operate taxable REIT subsidiaries subject to tax on any taxable income earned.