

Arlington Asset Investment Corp.  
Form 10-Q  
August 01, 2014

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

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 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: 001-34374**

# ARLINGTON ASSET INVESTMENT CORP.

(Exact name of Registrant as specified in its charter)

Virginia  
(State or Other Jurisdiction of  
Incorporation or Organization)

54-1873198  
(I.R.S. Employer  
Identification No.)

1001 Nineteenth Street North  
Arlington, VA  
(Address of Principal Executive Offices)

22209  
(Zip Code)

**(703) 373-0200**

(Registrant's Telephone Number, Including Area Code)

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

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

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

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 Exchange Act): Yes  No

Number of shares outstanding of each of the registrant's classes of common stock, as of July 31, 2014:

| Title                | Outstanding       |
|----------------------|-------------------|
| Class A Common Stock | 19,263,688 shares |
| Class B Common Stock | 449,228 shares    |



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# PART I

## FINANCIAL INFORMATION

### Item 1. Financial Statements (unaudited)

## ARLINGTON ASSET INVESTMENT CORP.

### CONSOLIDATED BALANCE SHEETS (Dollars in thousands) (Unaudited)

|   | June 30, 2014      | December 31,<br>2013 |
|---|--------------------|----------------------|
| <b>ASSETS</b>   |                    |                      |
| Cash and cash equivalents   | \$26,954           | \$48,628             |
| Receivables   |                    |                      |
| Interest  | 8,908              | 5,173                |
| Other   | 212                | 212                  |
| Mortgage-backed securities, at fair value                             |                    |                      |
| Available-for-sale  | 314,189            | 341,346              |
| Trading   | 2,813,983          | 1,576,452            |
| Other investments   | 2,057              | 2,065                |
| Derivative assets, at fair value                                      | 2,556              | 8,424                |
| Deferred tax assets, net  | 151,669            | 165,851              |
| Deposits  | 109,680            | 45,504               |
| Prepaid expenses and other assets                                     | 1,530              | 1,311                |
| Total assets  | <b>\$3,431,738</b> | <b>\$2,194,966</b>   |
| <b>LIABILITIES AND EQUITY</b>   |                    |                      |
| Liabilities:  |                    |                      |
| Repurchase agreements   | \$2,666,251        | \$1,547,630          |
| Interest payable  | 871                | 774                  |
| Accrued compensation and benefits                                     | 2,857              | 5,584                |
| Dividend payable  | 17,348             | 14,630               |
| Derivative liabilities, at fair value                                 | 80,487             | 33,129               |
| Accounts payable, accrued expenses and other liabilities              | 1,292              | 1,391                |
| Long-term debt  | 40,000             | 40,000               |
| Total liabilities   | <b>2,809,106</b>   | <b>1,643,138</b>     |
| Commitments and contingencies   |                    |                      |
| Equity:   |                    |                      |
| Preferred stock, \$0.01 par value, 25,000,000 shares authorized, none |                    |                      |

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|  |                    |                    |
|--|--------------------|--------------------|
| issued and outstanding   |                    |                    |
| Class A common stock, \$0.01 par value, 450,000,000 shares authorized, 19,263,688 and 16,047,965 shares issued and outstanding, respectively | 193                | 160                |
| Class B common stock, \$0.01 par value, 100,000,000 shares authorized, 449,228 and 554,055 shares issued and outstanding, respectively       | 4                  | 6                  |
| Additional paid-in capital   | 1,810,297          | 1,727,398          |
| Accumulated other comprehensive income, net of taxes of \$7,914 and \$9,436, respectively  | 49,848             | 53,190             |
| Accumulated deficit  | (1,237,710)        | (1,228,926 )       |
| Total equity   | <b>622,632</b>     | <b>551,828</b>     |
| Total liabilities and equity   | <b>\$3,431,738</b> | <b>\$2,194,966</b> |

See notes to consolidated financial statements.

TABLE OF CONTENTS**ARLINGTON ASSET INVESTMENT CORP.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE  
INCOME****(Dollars in thousands, except per share data)  
(Unaudited)**

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2014                           | 2013     | 2014                         | 2013     |
| Interest income  | \$30,063                       | \$23,145 | \$53,930                     | \$41,473 |
| Interest expense   |                                |          |                              |          |
| Interest on short-term debt  | 2,124                          | 1,814    | 3,858                        | 3,303    |
| Interest on long-term debt   | 552                            | 406      | 1,103                        | 521      |
| Total interest expense   | 2,676                          | 2,220    | 4,961                        | 3,824    |
| Net interest income  | 27,387                         | 20,925   | 48,969                       | 37,649   |
| Other income (loss), net   |                                |          |                              |          |
| Investment gain (loss), net  | 7,910                          | (11,253) | 1,999                        | (24,782) |
| Other loss   | (4 )                           | (4 )     | (7 )                         | (8 )     |
| Total other income (loss), net   | 7,906                          | (11,257) | 1,992                        | (24,790) |
| Operating income before other expenses   | 35,293                         | 9,668    | 50,961                       | 12,859   |
| Other expenses   |                                |          |                              |          |
| Compensation and benefits  | 3,185                          | 2,643    | 6,146                        | 4,992    |
| Professional services  | 395                            | 555      | 911                          | 1,676    |
| Business development   | 56                             | 30       | 87                           | 62       |
| Occupancy and equipment  | 120                            | 111      | 219                          | 232      |
| Communications   | 52                             | 46       | 99                           | 93       |
| Other operating expenses   | 572                            | 535      | 1,073                        | 641      |
| Total other expenses   | 4,380                          | 3,920    | 8,535                        | 7,696    |
| Income before income taxes   | 30,913                         | 5,748    | 42,426                       | 5,163    |
| Income tax provision (benefit)   | 12,074                         | 2,554    | 16,554                       | (1,208 ) |
| Net income   | \$18,839                       | \$3,194  | \$25,872                     | \$6,371  |
| Basic earnings per share   | \$0.95                         | \$0.19   | \$1.42                       | \$0.42   |
| Diluted earnings per share   | \$0.94                         | \$0.19   | \$1.39                       | \$0.41   |
| Weighted-average shares outstanding (in thousands)   |                                |          |                              |          |
| Basic  | 19,740                         | 16,655   | 18,282                       | 15,299   |
| Diluted  | 20,060                         | 16,832   | 18,579                       | 15,470   |
| Other comprehensive income, net of taxes   |                                |          |                              |          |
| Unrealized gains (losses) for the period on<br>available-for-sale securities (net of taxes of \$(619),<br>\$5,927, \$(1,235), and \$9,255, respectively) | \$3,081                        | \$8,528  | \$5,425                      | \$13,318 |
| Reclassification   |                                |          |                              |          |



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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Included in investment gains (loss), net, in the statement of comprehensive income related to sales of available-for-sale securities (net of taxes of \$175, \$2,215, \$318, and \$2,370, respectively)                            | (4,368 ) | (3,187 ) | (8,816 ) | (3,410 ) |
| Included in investment gain (loss), net, in the statement of comprehensive income related to other-than-temporary impairment charges on available-for-sale securities (net of taxes of \$31, \$298, \$31, and \$365, respectively) | 49       | 430      | 49       | 525      |
| Comprehensive income   | \$17,601 | \$8,965  | \$22,530 | \$16,804 |

See notes to consolidated financial statements.

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**ARLINGTON ASSET INVESTMENT CORP.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN**  
**EQUITY**  
**(Dollars in thousands)**  
**(Unaudited)**

See notes to consolidated financial statements.

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**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Dollars in thousands)**  
**(Unaudited)**

|  | Six Months Ended June 30, |           |
|--|---------------------------|-----------|
|  | 2014                      | 2013      |
| Cash flows from operating activities:  |                           |           |
| Net income   | \$25,872                  | \$6,371   |
| Adjustments to reconcile net income to net cash provided by operating activities |                           |           |
| Net investment (gain) loss   | (1,999 )                  | 24,782    |
| Net discount accretion on mortgage-backed securities                             | (6,725 )                  | (3,878 )  |
| Deferred tax provision   | 15,704                    | 1,851     |
| Other  | 1,264                     | 943       |
| Changes in operating assets  |                           |           |
| Interest receivable  | (3,735 )                  | (1,098 )  |
| Other receivables  |                           | 391       |
| Prepaid expenses and other assets  | (7,997 )                  | (467 )    |
| Changes in operating liabilities   |                           |           |
| Accounts payable and other liabilities   | (2 )                      | (3,241 )  |
| Accrued compensation and benefits  | (2,727 )                  | 1,051     |
| Net cash provided by operating activities  | 19,655                    | 26,705    |
| Cash flows from investing activities:  |                           |           |
| Purchases of available-for-sale mortgage-backed securities                       |                           | (122,840) |
| Purchases of trading mortgage-backed securities                                  | (1,253,498)               | (964,033) |
| Proceeds from sales of available-for-sale mortgage-backed securities             | 37,231                    | 27,798    |
| Proceeds from sales of trading mortgage-backed securities                        |                           | 500,303   |
| Receipt of principal payments on available-for-sale mortgage-backed securities   | 1,389                     | 2,997     |
| Receipt of principal payments on trading mortgage-backed securities              | 78,422                    | 81,285    |
| Proceeds from sold securities receivable   |                           | 26,773    |
| (Payments for) proceeds from derivatives and deposits, net                       | (73,238 )                 | 48,823    |
| Other  | 13                        | 85        |
| Net cash used in investing activities  | (1,209,681)               | (398,809) |
| Cash flows from financing activities:  |                           |           |
| Proceeds from repurchase agreements, net   | 1,118,621                 | 278,125   |
| Proceeds from stock issuance, net  | 81,669                    | 86,964    |
| Proceeds from long-term debt issuance, net                                       |                           | 24,038    |
| Dividends paid   | (31,938 )                 | (14,587 ) |
| Net cash provided by financing activities  | 1,168,352                 | 374,540   |
| Net (decrease) increase in cash and cash equivalents                             | (21,674 )                 | 2,436     |

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|  |          |          |
|--|----------|----------|
| Cash and cash equivalents, beginning of period | 48,628   | 35,837   |
| Cash and cash equivalents, end of period       | \$26,954 | \$38,273 |
| Supplemental cash flow information             |          |          |
| Cash payments for interest                     | \$4,813  | \$3,579  |
| Cash payments for taxes                        | \$789    | \$345    |

See notes to consolidated financial statements.

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**ARLINGTON ASSET INVESTMENT CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Dollars in thousands, except per share data)  
(Unaudited)**

**1. Basis of Presentation:**

The consolidated financial statements of Arlington Asset Investment Corp. (Arlington Asset) and its subsidiaries (unless the context otherwise provides, collectively, the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q. Therefore, they do not include all information required by GAAP for complete financial statements. The interim financial statements reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the results for the periods presented. All significant intercompany accounts and transactions have been eliminated in consolidation. The results of operations for the three and six months ended June 30, 2014 are not necessarily indicative of the operating results for the entire year or any other subsequent interim period. The Company's unaudited consolidated financial statements and notes thereto should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

The preparation of the Company's financial statements in conformity with GAAP requires the Company to make estimates and assumptions affecting the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although the Company based the estimates and assumptions on historical experience, when available, market information, and on various other factors that the Company believes to be reasonable under the circumstances, management exercises significant judgment in the final determination of the estimates. Actual results may differ from these estimates.

Certain amounts in the consolidated financial statements and notes for prior periods have been reclassified to conform to the current period presentation. These reclassifications had no effect on the results of operations of the Company.

**2. Financial Instruments:**

**Fair Value of Financial Instruments**

The accounting principles related to fair value measurements define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not adjusted for transaction costs. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures* (ASC 820), establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels giving the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3) as described below:

|                   |   |
|-------------------|---|
| Level 1<br>Inputs | Unadjusted quoted prices in active markets for identical assets or liabilities that are accessible by the Company;  |
| Level 2<br>Inputs | Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and |
| Level 3<br>Inputs | Unobservable inputs for the asset or liability, including significant assumptions of the Company and other market participants.                           |

The Company determines fair values for the following assets and liabilities:

**Mortgage-backed securities (MBS), at fair value**

Agency-backed MBS The Company's agency-backed MBS, the principal and interest payments on which are guaranteed by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac), are generally classified within Level 2 of the fair value hierarchy as they are valued after considering quoted market prices provided by a broker or dealer, or alternative pricing

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**ARLINGTON ASSET INVESTMENT CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Dollars in thousands, except per share data)  
(Unaudited)**

**2. Financial Instruments: (continued)**

sources with reasonable levels of price transparency. The Company reviews broker or pricing service quotes to determine whether the quotes are relevant, for example, whether an active market exists to provide price transparency or whether the quote is an indicative price or a binding offer. The independent brokers and dealers providing market prices are those who make markets in or specialists with expertise in the valuation of these financial instruments.

**Private-label MBS** The Company classifies non-agency-backed, or private-label, MBS within Level 3 of the fair value hierarchy because they trade infrequently and, therefore, have little or no price transparency. The Company utilizes present value techniques based on estimated cash flows of the instrument taking into consideration various assumptions derived by management and other assumptions used by other market participants. These assumptions are corroborated by evidence such as historical data, risk characteristics, transactions in similar instruments, and completed or pending transactions, when available. The significant inputs in the Company's valuation process include default rate, loss severity, prepayment rate and discount rate. In general, significant increases (decreases) in default rate, loss severity or discount rate, in isolation, would result in a significantly lower (higher) fair value measurement. However, significant increases (decreases) in prepayment rate may result in a significantly higher (lower) fair value measurement. It is difficult to generalize the interrelationships between these significant inputs as the actual results could differ considerably on an individual security basis. For example, an increase in the default rate may not increase the loss severity rate if actual losses are lower than the average. Also, changes in discount rates may be greatly influenced by market expectation at any given point based upon many variables not directly related to the MBS market. Therefore, each significant input is closely analyzed to ascertain the reasonableness for the Company's valuation purposes.

Establishing fair value is inherently subjective given the volatile and sometimes illiquid markets for these private-label MBS and requires management to make a number of assumptions, including assumptions about the future of interest rates, prepayment rates, discount rates, credit loss rates, and the timing of cash flows and credit losses. The assumptions the Company applies are specific to each security. Although the Company relies on its internal calculations to compute the fair value of these private-label MBS, the Company requests and considers indications of value, or the mark, from third-party dealers and the actual sales of private-label MBS to assist in the valuation process and calibrate our model.

**Other investments** The Company's other investments, which are classified within Level 3 of the fair value hierarchy, consist of investments in equity securities, investment funds and other MBS-related securities, such as interest-only MBS.

**Derivative instruments** In the normal course of the Company's operations, the Company is a party to various financial instruments that are accounted for as derivatives in accordance with ASC 815, *Derivatives and Hedging* (ASC 815).

The derivative instruments that trade in active markets or exchanges are classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices. Other derivative instruments are generally classified within Level 2 of the fair value hierarchy because they are valued using broker or dealer quotations, which are model-based calculations based on market-based inputs, including, but not limited to, contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs.

*Other* Cash and cash equivalents, interest receivable, deposits, other receivable, interest payable, accounts payable, accrued expenses and other liabilities are reflected in the consolidated balance sheets at their amortized cost (which approximates fair value because of the short term nature of these instruments) and classified within Level 1 of the fair value hierarchy, except for certain cash equivalents that are held in money market funds that are classified within Level 2 of the fair value hierarchy.



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(Dollars in thousands, except per share data)  
(Unaudited)****2. Financial Instruments: (continued)**

Sold securities receivable, repurchase agreements and purchased securities payable are reflected in the consolidated balance sheets at the cost basis, which approximates fair value because of the short term nature of these instruments, and classified within Level 2 of the fair value hierarchy.

Long-term debt represents remaining balances of trust preferred debt and senior debt issued by the Company. Trust preferred debt is classified within Level 3 of the fair value hierarchy as the fair value is determined after considering quoted market prices provided by a broker or dealer. The independent brokers or dealers providing market prices are those who make markets in or specialists with expertise in the valuation of these financial instruments. The Company's senior debt, which is publicly traded on the New York Stock Exchange, is classified within Level 1 of the fair value hierarchy.

The estimated fair values of the Company's financial instruments are as follows:

|                           | June 30, 2014   |                      | December 31, 2013 |                      |
|---------------------------|-----------------|----------------------|-------------------|----------------------|
|                           | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| Financial assets          |                 |                      |                   |                      |
| Cash and cash equivalents | \$26,954        | \$26,954             | \$48,628          | \$48,628             |
| Interest receivable       | 8,908           | 8,908                | 5,173             | 5,173                |
| Other receivables         | 212             | 212                  | 212               | 212                  |
| MBS                       |                 |                      |                   |                      |
| Agency-backed MBS         | 2,814,024       | 2,814,024            | 1,576,499         | 1,576,499            |
| Private-label MBS         |                 |                      |                   |                      |
| Senior securities         |                 |                      | 7,066             | 7,066                |
| Re-REMIC securities       | 314,148         | 314,148              | 334,233           | 334,233              |
| Derivative assets         | 2,556           | 2,556                | 8,424             | 8,424                |
| Other investments         | 2,057           | 2,057                | 2,065             | 2,065                |
| Deposits                  | 109,680         | 109,680              | 45,504            | 45,504               |
| Financial liabilities     |                 |                      |                   |                      |
| Repurchase agreements     | 2,666,251       | 2,666,251            | 1,547,630         | 1,547,630            |
| Interest payable          | 871             | 871                  | 774               | 774                  |
| Long-term debt            | 40,000          | 39,500               | 40,000            | 36,620               |
| Derivative liabilities    | 80,487          | 80,487               | 33,129            | 33,129               |
|                           | 1,292           | 1,292                | 1,391             | 1,391                |

Accounts payable, accrued expenses and other  
liabilities

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|                                       |             |              |             |            |
|---------------------------------------|-------------|--------------|-------------|------------|
| Private-label MBS                     |             |              |             |            |
| Senior securities                     | 7,066       |              |             | 7,066      |
| Re-REMIC securities                   | 334,233     |              |             | 334,233    |
| Total available-for-sale              | 341,346     |              | 47          | 341,299    |
| Total MBS                             | 1,917,798   |              | 1,576,499   | 341,299    |
| Derivative assets, at fair value      | 8,424       | 8,088        | 336         |            |
| Derivative liabilities, at fair value | (33,129 )   | (32,156 )    | (973 )      |            |
| Interest-only MBS, at fair value      | 298         |              |             | 298        |
| Total                                 | \$1,893,391 | \$ (24,068 ) | \$1,575,862 | \$ 341,597 |

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**ARLINGTON ASSET INVESTMENT CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Dollars in thousands, except per share data)  
(Unaudited)**

**2. Financial Instruments: (continued)**

The total financial assets measured and reported at fair value on a recurring basis and classified within Level 3 were \$314,385, or 9.16%, and \$341,597, or 15.56%, of the Company's total assets as of June 30, 2014 and December 31, 2013, respectively.

There were no transfers of securities in or out of Levels 1, 2 or 3 during the three and six months ended June 30, 2014 or the year ended December 31, 2013.

**Level 3 Financial Assets and Liabilities**

**Financial Instruments Measured at Fair Value on a Recurring Basis**

The fair value of the Company's Level 3, available-for-sale, private-label MBS was \$314,148 and \$341,299 as of June 30, 2014 and December 31, 2013, respectively. The private-label MBS are primarily senior and re-REMIC tranches in securitization trusts issued between 2005 and 2010. The senior securities represent interests in securitizations that have the first right to cash flows and absorb losses last. The re-REMIC securities represent interests in re-securitizations of senior MBS and pro-rata mezzanine securities. For re-REMIC securities, the cash flows from, and any credit losses absorbed by, the underlying MBS are allocated among the re-REMIC securities issued in the re-securitization transactions based on the re-REMIC structure. For example, prime and non-prime residential senior securities have been resecured to create a two-tranche structure with a re-REMIC senior security and a re-REMIC subordinated security. In these re-REMIC securities, all principal payments from the underlying securities are directed to the re-REMIC senior security until the face value is fully paid off. Thereafter, all principal payments are directed to the re-REMIC subordinated security. For pro-rata mezzanine securities, principal payments from the underlying MBS are typically allocated concurrently and proportionally to the mezzanine securities along with senior securities. The re-REMIC subordinated and mezzanine securities absorb credit losses, if any, first; however, these credit losses occur only when credit losses exceed the credit protection provided to the underlying securities. Senior, re-REMIC and mezzanine securities receive interest while any face value is outstanding.

The Company's private-label MBS were collateralized by residential prime and Alt-A mortgage loans and had the following weighted average characteristics, based on face value, as of the dates indicated:

|                        | June 30, 2014 |   | December 31, 2013 |   |
|------------------------|---------------|---|-------------------|---|
| Original loan-to-value | 68            | % | 69                | % |
| Original FICO score    | 724           |   | 725               |   |

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|                             |      |   |      |   |
|-----------------------------|------|---|------|---|
| Three-month prepayment rate | 11   | % | 14   | % |
| Three-month loss severities | 32   | % | 37   | % |
| Weighted average coupon     | 3.00 | % | 3.34 | % |

The significant unobservable inputs for the valuation model include the following weighted-averages, based on face value, as of the dates indicated:

|                    | June 30, 2014     |                     | December 31, 2013 |                     |
|--------------------|-------------------|---------------------|-------------------|---------------------|
|                    | Senior Securities | Re-REMIC Securities | Senior Securities | Re-REMIC Securities |
| Discount rate      | %                 | 6.51 %              | 6.00 %            | 6.55 %              |
| Default rate       | %                 | 3.13 %              | 9.30 %            | 3.62 %              |
| Loss severity rate | %                 | 42.12 %             | 50.00 %           | 44.82 %             |
| Prepayment rate    | %                 | 11.29 %             | 16.30 %           | 11.69 %             |

(1) The Company did not own any senior securities on June 30, 2014.

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The ranges of the significant unobservable inputs for the valuation model were as follows as of the dates indicated:

|                    | June 30, 2014        |                        |       | December 31, 2013    |                        |                |
|--------------------|----------------------|------------------------|-------|----------------------|------------------------|----------------|
|                    | Senior<br>Securities | Re-REMIC<br>Securities | (1)   | Senior<br>Securities | Re-REMIC<br>Securities |                |
| Discount rate      | %                    | 6.00                   | 10.00 | %                    | 6.00                   | % 6.00 10.00 % |
| Default rate       | %                    | 1.00                   | 8.80  | %                    | 9.30                   | % 0.95 9.60 %  |
| Loss severity rate | %                    | 29.29                  | 57.50 | %                    | 50.00                  | % 29.15 57.50% |
| Prepayment rate    | %                    | 7.40                   | 17.70 | %                    | 16.30                  | % 6.40 19.00 % |

(1) The Company did not own any senior securities on June 30, 2014.

The tables below set forth a summary of changes in the fair value and gains and losses of the Company's Level 3 financial assets and liabilities that are measured at fair value on a recurring basis for the three and six months ended June 30, 2014 and 2013.

|  | Three Months Ended June 30,<br>2014 |                        |           |
|--|-------------------------------------|------------------------|-----------|
|  | Senior<br>Securities                | Re-REMIC<br>Securities | Total     |
| Beginning balance, April 1, 2014   | \$                                  | \$329,846              | \$329,846 |
| Total net gains (losses)   |                                     |                        |           |
| Included in earnings   | 6                                   | 4,759                  | 4,765     |
| Included in other comprehensive income   |                                     | (2,019 )               | (2,019 )  |
| Purchases  |                                     |                        |           |
| Sales  | 78                                  | (21,576 )              | (21,498 ) |
| Payments, net  | (104)                               | (3,711 )               | (3,815 )  |
| Accretion of discount  | 20                                  | 6,849                  | 6,869     |
| Ending balance, June 30, 2014  | \$                                  | \$314,148              | \$314,148 |
| The amount of net gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting date | \$                                  | \$(51 )                | \$(51 )   |

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|  | Three Months Ended June 30,<br>2013 |                        |           |
|--|-------------------------------------|------------------------|-----------|
|  | Senior<br>Securities                | Re-REMIC<br>Securities | Total     |
| Beginning balance, April 1, 2013   | \$7,400                             | \$268,456              | \$275,856 |
| Total net gains (losses)   |                                     |                        |           |
| Included in earnings   |                                     | 6,342                  | 6,342     |
| Included in other comprehensive income   | (123 )                              | 9,936                  | 9,813     |
| Purchases  |                                     | 59,325                 | 59,325    |
| Sales  |                                     | (23,019 )              | (23,019 ) |
| Payments, net  | (255 )                              | (5,752 )               | (6,007 )  |
| Accretion of discount  | 224                                 | 6,386                  | 6,610     |
| Ending balance, June 30, 2013  | \$7,246                             | \$321,674              | \$328,920 |
| The amount of net gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting date | \$                                  | \$(728 )               | \$(728 )  |

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|  | Six Months Ended June 30, 2014 |                     |           |
|--|--------------------------------|---------------------|-----------|
|  | Senior Securities              | Re-REMIC Securities | Total     |
| Beginning balance, January 1, 2014   | \$7,066                        | \$334,233           | \$341,299 |
| Total net gains (losses)   |                                |                     |           |
| Included in earnings   | 1,690                          | 7,842               | 9,532     |
| Included in other comprehensive income   | (1,654)                        | (3,210)             | (4,864)   |
| Purchases  |                                |                     |           |
| Sales  | (7,029)                        | (30,202)            | (37,231)  |
| Payments, net  | (319)                          | (8,288)             | (8,607)   |
| Accretion of discount  | 246                            | 13,773              | 14,019    |
| Ending balance, June 30, 2014  | \$                             | \$314,148           | \$314,148 |
| The amount of net gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting date | \$                             | \$(51)              | \$(51)    |

|  | Six Months Ended June 30, 2013 |                     |           |
|--|--------------------------------|---------------------|-----------|
|  | Senior Securities              | Re-REMIC Securities | Total     |
| Beginning balance, January 1, 2013   | \$7,519                        | \$191,567           | \$199,086 |
| Total net gains (losses)   |                                |                     |           |
| Included in earnings   |                                | 7,790               | 7,790     |
| Included in other comprehensive income   | (87)                           | 17,803              | 17,716    |
| Purchases  |                                | 131,203             | 131,203   |
| Sales  |                                | (27,798)            | (27,798)  |
| Payments, net  | (638)                          | (10,758)            | (11,396)  |
| Accretion of discount  | 452                            | 11,867              | 12,319    |
| Ending balance, June 30, 2013  | \$7,246                        | \$321,674           | \$328,920 |
| The amount of net gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting date | \$                             | \$(890)             | \$(890)   |

Gains and losses included in earnings for the three and six months ended June 30, 2014 and 2013 are reported in the following statement of comprehensive income line descriptions:

|  | Other Income (Loss), Investment Gain<br>(Loss), net |          |                              |          |
|--|---|----------|------------------------------|----------|
|  | Three Months<br>Ended June 30,                      |          | Six Months Ended<br>June 30, |          |
|  | 2014  | 2013     | 2014                         | 2013     |
| Total gains (losses) included in earnings for the period                                       | \$4,765   | \$6,342  | \$9,532                      | \$7,790  |
| Change in unrealized gains (losses) relating to Level 3 assets<br>still held at reporting date | \$(51 )   | \$(728 ) | \$(51 )                      | \$(890 ) |

**Level 3 Financial Instruments Measured at Fair Value on a Non-Recurring Basis**

The Company also measures certain financial assets at fair value on a non-recurring basis. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets due to impairments. Due to the nature of these financial assets, enterprise values are primarily used to value these financial assets. In determining the enterprise value, the Company analyzes various financial, performance and market factors to estimate fair value, including where applicable,

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market trading activity. As a result, these financial assets are classified within Level 3 of the fair value hierarchy. As of June 30, 2014 and December 31, 2013, these financial assets are classified within the other investments category, represent the Company's interest in non-public equity securities and investment funds and are valued at \$1,820 and \$1,767, respectively. For the six months ended June 30, 2013, the Company recorded losses of \$138 in the carrying value of these financial assets. For the three months ended June 30, 2013 and for the three and six months ended June 30, 2014, there were no changes to the carrying value of these financial assets.

**MBS, at Fair Value**

MBS, at fair value<sup>(1)(2)</sup>, consisted of the following as of the dates indicated:

|                            | June 30, 2014 |                                    |                             |                       | December 31, 2013                      |             |                                    |                             |                       |  |
|----------------------------|---------------|------------------------------------|-----------------------------|-----------------------|--|-------------|------------------------------------|-----------------------------|-----------------------|--|
|                            | Fair Value    | Net Unamortized Premium (Discount) | Percent of Total Fair Value | Weighted Average Life | Weighted Average Rating <sup>(3)</sup> | Fair Value  | Net Unamortized Premium (Discount) | Percent of Total Fair Value | Weighted Average Life | Weighted Average Rating <sup>(3)</sup> |
| <b>Trading</b>             |               |                                    |                             |                       |  |             |                                    |                             |                       |  |
| Fannie Mae                 | \$1,661,538   | \$                                 | 53.12 %                     | 9.1                   | AAA                                    | \$997,488   | \$                                 | 52.01 %                     | 9.4                   | AAA                                    |
| Freddie Mac                | 1,152,445     |                                    | 36.84 %                     | 9.3                   | AAA                                    | 578,964     |                                    | 30.19 %                     | 9.6                   | AAA                                    |
| <b>Available-for-sale:</b> |               |                                    |                             |                       |  |             |                                    |                             |                       |  |
| <b>Agency-backed</b>       |               |                                    |                             |                       |  |             |                                    |                             |                       |  |
| Fannie Mae                 | 41            |                                    |                             | 5.3                   | AAA                                    | 47          |                                    |                             | 5.8                   | AAA                                    |
| <b>Private-label</b>       |               |                                    |                             |                       |  |             |                                    |                             |                       |  |
| Senior securities          |               |                                    |                             |                       |  | 7,066       | (4,789 )                           | 0.37 %                      | 4.8                   | C-                                     |
| <b>Re-REMIC securities</b> |               |                                    |                             |                       |  |             |                                    |                             |                       |  |
|                            | 314,148       | (167,491)                          | 10.04 %                     | 10.9                  | NR                                     | 334,233     | (202,450)                          | 17.43 %                     | 11.4                  | NR                                     |
|                            | \$3,128,172   | \$(167,491)                        | 100.00 %                    |                       |  | \$1,917,798 | \$(207,239)                        | 100.00 %                    |                       |  |

<sup>(1)</sup> The Company's MBS portfolio was primarily comprised of fixed-rate MBS at June 30, 2014 and December 31, 2013. The weighted-average coupon of the MBS portfolio at June 30, 2014 and December 31, 2013 was 3.90%.

<sup>(2)</sup> As of June 30, 2014 and December 31, 2013, the Company's MBS investments with a fair value of \$2,876,593 and \$1,673,911, respectively, were pledged as collateral for repurchase agreements.

<sup>(3)</sup> The securities issued by Fannie Mae and Freddie Mac are not rated by any rating agency; however, they are commonly thought of as having an implied rating of AAA. There is no assurance, particularly given the downgrade

of the U.S. credit rating to AA+ by Standard & Poor's during the quarter ended September 30, 2011 and Fitch Ratings Inc.'s announcement on October 15, 2013 that it had placed the U.S. credit rating on negative watch, that these securities would receive such a rating if they were ever rated by a rating agency. The weighted-average rating of the Company's private-label senior securities is calculated based on face value of the securities.

The Company has generally purchased private-label MBS at a discount. The Company, at least on a quarterly basis, estimates the future expected cash flows based on the Company's observation of current information and events and applies a number of assumptions related to prepayment rates, interest rates, default rates, loss severity rates, and the timing and amount of cash flows and credit losses. These assumptions are difficult to predict as they are subject to uncertainties and contingencies related to future events that may impact the Company's estimates and its interest income.

Interest income on the private-label MBS that were purchased at a discount to face value is recognized based on the security's expected effective interest rate. At acquisition, the accretable yield is calculated as the difference between the undiscounted expected cash flows and the purchase price which is expected to be

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accreted into interest income over the remaining life of the security on a level-yield basis. The difference between the contractually required payments and the undiscounted expected cash flows represents the non-accretable difference.

Based on actual payment activities and changes in estimates of undiscounted expected future cash flows, the accretable yield and the non-accretable difference can change over time. Significant increases in the amount or timing of undiscounted expected future cash flows are recognized prospectively as an adjustment to the accretable yield.

The following table presents the changes in the accretable yield on available-for-sale, private-label MBS for the three and six months ended June 30, 2014 and 2013:

|                        | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|------------------------|-----------------------------|------------|---------------------------|------------|
|                        | 2014                        | 2013       | 2014                      | 2013       |
| Beginning balance      | \$ 310,933                  | \$ 261,391 | \$ 326,330                | \$ 207,853 |
| Accretion of discount  | (6,869 )                    | (6,610 )   | (14,019 )                 | (12,319 )  |
| Reclassifications, net | 8,727                       | 28,702     | 13,372                    | 32,609     |
| Acquisitions           |                             | 50,871     |                           | 113,745    |
| Sales                  | (21,663 )                   | (16,659 )  | (34,555 )                 | (24,193 )  |
| Ending balance         | \$ 291,128                  | \$ 317,695 | \$ 291,128                | \$ 317,695 |

For the available-for-sale, private-label MBS acquired during the three and six months ended June 30, 2014 and 2013, the contractually required payments receivable, the cash flow expected to be collected, and the fair value at the acquisition date were as follows for the dates indicated:

|  | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|--|-----------------------------|------------|---------------------------|------------|
|  | 2014                        | 2013       | 2014                      | 2013       |
| Contractually required payments receivable | \$                          | \$ 148,689 | \$                        | \$ 332,860 |
| Cash flows expected to be collected        |                             | 110,195    |                           | 244,948    |
| Basis in acquired securities               |                             | 59,324     |                           | 131,203    |

The Company's available-for-sale MBS are carried at fair value in accordance with ASC 320, *Debt and Equity Securities* (ASC 320), with resulting unrealized gains and losses reflected as other comprehensive income or loss.

Gross unrealized gains and losses on these securities were the following as of the dates indicated:

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|                     | June 30, 2014        |            |          |            |
|---------------------|----------------------|------------|----------|------------|
|                     | Amortized            | Unrealized |          | Fair Value |
|                     | Cost/Cost            | Gains      | Losses   |            |
|                     | Basis <sup>(1)</sup> |            |          |            |
| Agency-backed MBS   | \$ 37                | \$ 4       | \$       | \$ 41      |
| Private-label MBS   |                      |            |          |            |
| Senior securities   |                      |            |          |            |
| Re-REMIC securities | 256,389              | 57,783     | (24 )    | 314,148    |
| Total               | \$ 256,426           | \$ 57,787  | \$ (24 ) | \$ 314,189 |

(1) The amortized cost of MBS includes unamortized net discounts of \$167,491 at June 30, 2014.

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|                     | December 31, 2013                              |                     |         | Fair Value |
|---------------------|--|---------------------|---------|------------|
|                     | Amortized<br>Cost/Cost<br>Basis <sup>(1)</sup> | Unrealized<br>Gains | Losses  |            |
| Agency-backed MBS   | \$ 43  | \$ 4                | \$      | \$ 47      |
| Private-label MBS   |  |                     |         |            |
| Senior securities   | 5,412  | 1,654               |         | 7,066      |
| Re-REMIC securities | 273,264  | 60,970              | (1 )    | 334,233    |
| Total               | \$ 278,719                                     | \$ 62,628           | \$ (1 ) | \$ 341,346 |

(1) The amortized cost of MBS includes unamortized net discounts of \$207,239 at December 31, 2013. For the three and six months ended June 30, 2014, the Company recorded other-than-temporary impairment charges of \$51 as a component of investment gain (loss), net on the consolidated statements of comprehensive income related to deterioration in credit quality on available-for-sale, private-label MBS with a cost basis of \$2,174, prior to recognizing the other-than-temporary impairment charges. For the three and six months ended June 30, 2013, the Company recorded other-than-temporary impairment charges of \$728 and \$890, respectively, as a component of investment gain (loss), net on the consolidated statements of comprehensive income related to deterioration in credit quality on available-for-sale, private-label MBS with a cost basis of \$1,341 and \$1,584, respectively, prior to recognizing the other-than-temporary impairment charges.

The following table presents a summary of other-than-temporary impairment charges included in earnings for the periods indicated and cumulative other-than-temporary impairment charges recognized on the MBS held as of the dates indicated:

|   | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |          |
|---|--------------------------------|-----------|------------------------------|----------|
|   | 2014                           | 2013      | 2014                         | 2013     |
| Cumulative other-than-temporary impairment, beginning balance | \$21,027                       | \$ 22,555 | \$23,663                     | \$23,768 |
| Additions   |                                |           |                              |          |
| Other-than-temporary impairments not previously recognized    | 51                             |           | 51                           |          |
|   |                                | 728       |                              | 890      |

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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Increases related to other-than-temporary<br>impairments on securities with previously recognized<br>other-than-temporary impairments |          |          |          |          |
| Reductions  |          |          |          |          |
| Decreases related to other-than-temporary impairments on<br>sold securities   | (1,391 ) |          | (4,027 ) | (1,375 ) |
| Cumulative other-than-temporary impairment, ending<br>balance   | \$19,687 | \$23,283 | \$19,687 | \$23,283 |

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The following table presents the results of sales of MBS for the periods indicated:

|                     | Three Months Ended June 30, |                      |                      | Six Months Ended June 30, |                      |                      |                      |
|---------------------|-----------------------------|----------------------|----------------------|---------------------------|----------------------|----------------------|----------------------|
|                     | 2014                        | 2013                 |                      | 2014                      | 2013                 |                      |                      |
|                     | Agency-Backed<br>MBS        | Private-Label<br>MBS | Agency-Backed<br>MBS | Agency-Backed<br>MBS      | Private-Label<br>MBS | Agency-Backed<br>MBS | Private-Label<br>MBS |
| Proceeds from sales | \$ 21,499                   | \$ 196,113           | \$ 23,020            | \$ 37,231                 | \$ 527,738           | \$ 27,798            |                      |
| Gross gains         | 4,690                       | 529                  | 6,928                | 9,359                     | 531                  | 8,489                |                      |
| Gross losses        |                             | 1,655                |                      |                           | 6,973                |                      |                      |

**Other Investments**

The Company's other investments consisted of the following as of the dates indicated:

|                              | June 30,<br>2014 | December 31,<br>2013 |
|------------------------------|------------------|----------------------|
| Interest-only MBS            | \$ 237           | \$ 298               |
| Non-public equity securities | 975              | 975                  |
| Investment funds             | 845              | 792                  |
| Total other investments      | \$ 2,057         | \$ 2,065             |

**3. Borrowings:****Repurchase Agreements**

The Company has entered into repurchase agreements to fund its investments in MBS. Securities sold under agreements to repurchase, which are treated as financing transactions for financial reporting purposes, are collateralized by MBS and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements. Under the repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. The counterparty to the repurchase agreements may require that the Company pledge additional securities or cash as additional collateral to secure borrowings when the value of the collateral declines.

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As of June 30, 2014 and December 31, 2013, the Company had no amount at risk with a single repurchase agreement counterparty or lender greater than 10% of equity. The following tables provide information regarding the Company's outstanding repurchase agreement borrowings as of the dates and for the periods indicated:

|                                       | June 30, 2014 | December 31,<br>2013 |
|---------------------------------------|---------------|----------------------|
| Outstanding balance                   | \$ 2,666,251  | \$ 1,547,630         |
| Value of assets pledged as collateral |               |                      |
| Agency-backed MBS                     | 2,763,301     | 1,556,763            |
| Private-label MBS                     | 113,292       | 117,148              |
| Net amount <sup>(1)</sup>             | 210,342       | 126,281              |
| Weighted-average rate                 | 0.36 %        | 0.45 %               |
| Weighted-average term to maturity     | 14.0 days     | 13.2 days            |

<sup>(1)</sup> Net amount represents the value of collateral in excess of corresponding repurchase obligation. The amount of collateral at-risk is limited to the outstanding repurchase obligation and not the entire collateral balance.

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(Unaudited)****3. Borrowings: (continued)**

|  | June 30, 2014 | June 30, 2013 |
|--|---------------|---------------|
| Weighted-average outstanding balance during the three months ended | \$2,300,868   | \$1,660,108   |
| Weighted-average rate during the three months ended                | 0.37 %        | 0.43 %        |
| Weighted-average outstanding balance during the six months ended   | \$1,990,904   | \$1,466,485   |
| Weighted-average rate during the six months ended                  | 0.39 %        | 0.45 %        |

**Long-Term Debt**

As of June 30, 2014 and December 31, 2013, the Company had \$40,000 of outstanding long-term debentures. The Company's long-term debentures consisted of the following as of the dates indicated:

|                                | June 30, 2014 |                      | December 31, 2013 |                      |
|--------------------------------|---------------|----------------------|-------------------|----------------------|
|                                | Senior Notes  | Trust Preferred Debt | Senior Notes      | Trust Preferred Debt |
| Outstanding Principal          | \$25,000      | \$15,000             | \$25,000          | \$15,000             |
| Annual Interest Rate           | 6.625%        | LIBOR + 2.25 3.00%   | 6.625%            | LIBOR + 2.25 3.00%   |
| Interest Payment Frequency     | Quarterly     | Quarterly            | Quarterly         | Quarterly            |
| Weighted-Average Interest Rate | 6.625%        | 2.98%                | 6.625%            | 2.99%                |
| Maturity                       | May 1, 2023   | 2033 2035            | May 1, 2023       | 2033 2035            |
| Early Redemption Date          | May 1, 2016   | 2008 2010            | May 1, 2016       | 2008 2010            |

**4. Derivative Financial Instruments and Hedging Activities:**

In the normal course of its operations, the Company is a party to financial instruments that are accounted for as derivative financial instruments in accordance with ASC 815. These instruments may include interest rate swaps, Eurodollar futures, swap futures, and U.S. Treasury futures contracts, put options and certain commitments to purchase and sell MBS. The exchange traded derivatives such as Eurodollar futures and swap futures are cash settled on a daily basis. The Company may be required to pledge collateral for margin requirements with third-party custodians in connection with certain derivative transactions. These transactions are not under master netting agreements.



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(Dollars in thousands, except per share data)  
(Unaudited)****4. Derivative Financial Instruments and Hedging Activities:  
(continued)**

During the three and six months ended June 30, 2014 and 2013, the Company entered into various financial contracts to hedge certain MBS and related borrowings and other long-term debt. These financial contracts are not designated as hedges under ASC 815. The changes in fair value on these derivatives are recorded to net investment gain or loss in the statement of comprehensive income. For the three and six months ended June 30, 2014, the Company recorded net losses of \$46,585 and \$70,065, respectively, on these derivatives. For the three and six months ended June 30, 2013, the Company recorded net gains of \$57,776 and \$59,034, respectively, on these derivatives. The Company held the following derivative instruments as of the dates indicated:

|   | June 30, 2014   |            | December 31, 2013 |            |
|---|-----------------|------------|-------------------|------------|
|   | Notional Amount | Fair Value | Notional Amount   | Fair Value |
| No hedge designation                      |                 |            |                   |            |
| Eurodollar futures                        |                 |            |                   |            |
| Derivative assets                         | \$ 1,488,000    | \$ 701     | \$ 8,758,000      | \$ 4,361   |
| Derivative liabilities                    | 27,772,000      | (52,216 )  | 6,787,000         | (30,638 )  |
| Total Eurodollar futures <sup>(1)</sup>   | 29,260,000      | (51,515 )  | 15,545,000        | (26,277 )  |
| 10-year swap futures                      |                 |            |                   |            |
| Derivative assets                         |                 |            | 635,500           | 3,727      |
| Derivative liabilities                    | 895,000         | (27,009 )  | 31,000            | (18 )      |
| Total 10-year swap futures <sup>(2)</sup> | 895,000         | (27,009 )  | 666,500           | 3,709      |
| 5-year U.S. Treasury note futures         |                 |            | 100,000           | (1,500 )   |
| Commitment to purchase MBS <sup>(3)</sup> | 75,000          | 1,855      | 169,511           | (973 )     |
| Commitment to sell MBS <sup>(4)</sup>     | 125,000         | (1,262 )   | 125,000           | 336        |

The \$29,260,000 total notional amount of Eurodollar futures contracts as of June 30, 2014 represents the (1)accumulation of Eurodollar futures contracts that mature on a quarterly basis between 2014 and 2018. As of June 30, 2014, the Company maintained \$66,681 as a deposit and margin against the open Eurodollar futures contracts.

The \$895,000 represents the total notional amount of 10-year swap futures as of June 30, 2014, of which \$530,000 (2)of notional amount matures in September 2014 and \$365,000 in notional amount matures in March 2024. As of June 30, 2014, the Company maintained \$42,999 as a deposit and margin against the open 10-year swap futures contracts.

(3)The total notional amount of commitment to purchase MBS represents forward commitments to purchase fixed-rate MBS securities.

<sup>(4)</sup> The total notional amount of commitment to sell MBS represents forward commitments to sell fixed-rate MBS securities.

## 5. Income Taxes:

The total income tax provision for the three and six months ended June 30, 2014 was \$12,074 and \$16,554, respectively. The total income tax provision (benefit) for the three and six months ended June 30, 2013 was \$2,554 and \$(1,208), respectively. The Company generated pre-tax book income of \$30,913 and \$42,426 for the three and six months ended June 30, 2014, respectively. The Company generated pre-tax book income of \$5,748 and \$5,163 for the three and six months ended June 30, 2013, respectively.

The Company's effective tax rate for the six months ended June 30, 2014 and 2013 was 39.0% and (23.4%), respectively. The effective tax rate during the six months ended June 30, 2014 approximated the

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**ARLINGTON ASSET INVESTMENT CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Dollars in thousands, except per share data)  
(Unaudited)**

**5. Income Taxes: (continued)**

statutory rate. The effective tax rate during the six months ended June 30, 2013 was lower than the statutory tax rate due to the realization of previously unrecognized tax benefits, including related accrued interest, that were fully reserved.

As of June 30, 2014, the Company had a net deferred tax asset of \$151,669. The Company continues to provide a valuation allowance against the portion of the capital loss carryforwards which the Company believes is more likely than not that the benefits will not be realized prior to expiration. The Company will continue to assess the need for a valuation allowance at each reporting date.

As of June 30, 2014, the Company has assessed the need for a reserve against any uncertain tax position and has made the determination that such reserve is not necessary.

The Company is subject to examination by the U.S. Internal Revenue Service (IRS) and state and local taxing jurisdictions where the Company has significant business operations. As of June 30, 2014, there are no on-going examinations.

**6. Earnings Per Share:**

Basic earnings per share includes no dilution and is computed by dividing net income or loss applicable to common stock by the weighted-average number of common shares outstanding for the respective period. Diluted earnings per share includes the impact of dilutive securities such as stock options, unvested shares of restricted stock, and performance share units. The following tables present the computations of basic and diluted earnings per share for the periods indicated:

| (Shares in thousands)   | Three Months Ended June 30, |          |         |         |
|---|-----------------------------|----------|---------|---------|
|   | 2014                        |          | 2013    |         |
|   | Basic                       | Diluted  | Basic   | Diluted |
| Weighted-average shares outstanding                                   |                             |          |         |         |
| Common stock  | 19,740                      | 19,740   | 16,655  | 16,655  |
| Stock options, performance share units, and unvested restricted stock |                             | 320      |         | 177     |
| Weighted-average common and common equivalent shares outstanding      | 19,740                      | 20,060   | 16,655  | 16,832  |
| Net income applicable to common stock                                 | \$18,839                    | \$18,839 | \$3,194 | \$3,194 |

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Net income per common share \$0.95 \$0.94 \$0.19 \$0.19

|   | Six Months Ended June 30, |          |         |         |
|---|---------------------------|----------|---------|---------|
|   | 2014                      |          | 2013    |         |
| (Shares in thousands)   | Basic                     | Diluted  | Basic   | Diluted |
| Weighted-average shares outstanding                                   |                           |          |         |         |
| Common stock  | 18,282                    | 18,282   | 15,299  | 15,299  |
| Stock options, performance share units, and unvested restricted stock |                           | 297      |         | 171     |
| Weighted-average common and common equivalent shares outstanding      | 18,282                    | 18,579   | 15,299  | 15,470  |
| Net income applicable to common stock                                 | \$25,872                  | \$25,872 | \$6,371 | \$6,371 |
| Net income per common share   | \$1.42                    | \$1.39   | \$0.42  | \$0.41  |

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(Dollars in thousands, except per share data)  
(Unaudited)****6. Earnings Per Share: (continued)**

The diluted earnings per share for the three and six months ended June 30, 2014 did not include the antidilutive effect of 22,667 and 24,897 shares, respectively, of stock options, unvested shares of restricted stock, and performance share units. The diluted earnings per share for the three and six months ended June 30, 2013 did not include the antidilutive effect of 9,005 and 13,733 shares, respectively, of stock options, unvested shares of restricted stock, and performance share units.

**7. Equity:****Equity Offering**

During the six months ended June 30, 2014, the Company completed a public offering of its Class A Common Stock as follows:

|   |                |
|---|----------------|
| Closing date of the offering                                  | March 28, 2014 |
| Shares sold to public   | 2,750,000      |
| Shares sold pursuant to the underwriter over-allotment option | 312,500        |
| Total shares of Class A common stock sold in the offering     | 3,062,500      |
| Public offering price per share                               | \$27.40        |
| Net proceeds <sup>(1)</sup>                                   | \$81,669       |

(1) Net of underwriting discounts and commissions and expenses.

**Dividends**

Pursuant to the Company's variable dividend policy, the Board of Directors evaluates dividends on a quarterly basis and, in its sole discretion, approves the payment of dividends. The Company's dividend payments, if any, may vary significantly from quarter to quarter. The Board of Directors has approved and the Company has declared the following dividends to date in 2014:

| Quarter Ended | Dividend Amount | Declaration Date | Record Date | Pay Date |
|---------------|-----------------|------------------|-------------|----------|
| June 30       | \$ 0.875        | June 11          | June 30     | July 31  |
| March 31      | 0.875           | March 13         | March 31    | April 30 |

The Board of Directors approved and the Company declared and paid the following dividends for 2013:

| Quarter Ended | Dividend Amount | Declaration Date | Record Date  | Pay Date         |
|---------------|-----------------|------------------|--------------|------------------|
| December 31   | \$ 0.875        | December 19      | December 31  | January 31, 2014 |
| September 30  | 0.875           | September 18     | September 30 | October 31       |
| June 30       | 0.875           | June 17          | June 28      | July 31          |
| March 31      | 0.875           | March 15         | March 28     | April 30         |

### **Long-Term Incentive Plan**

On April 13, 2011, the Board of Directors adopted the Arlington Asset Investment Corp. 2011 Long-Term Incentive Plan (2011 Plan). The 2011 Plan was approved by the Company's shareholders and became effective on June 2, 2011.

Under the 2011 Plan, shares of Class A common stock of the Company may be issued to employees, directors, consultants and advisors of the Company and its affiliates. As of June 30, 2014 and December 31, 2013, 393,716 and 443,504 shares, respectively, remained available for issuance under the 2011 Plan.

### **Performance-Based Long-Term Incentive Program**

On August 13, 2012, the Compensation Committee of the Board of Directors of the Company adopted a performance-based long-term incentive program (Performance-based Program) that provides for the issuance of two types of performance share units (PSUs) pursuant to the Company's 2011 Plan.

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(Dollars in thousands, except per share data)  
(Unaudited)****7. Equity: (continued)**

The Compensation Committee established performance goals under the Performance-based Program. Two types of PSUs may be awarded under the Performance-based Program: Book Value PSUs and Total Shareholder Return Units (TSR PSUs). The Book Value PSUs are eligible to vest based on the compound annualized growth in the Company's book value per share (*i.e.*, book value change with such adjustments as determined and approved by the Compensation Committee plus dividends on a reinvested basis) during the applicable performance period. The TSR PSUs are eligible to vest based on the Company's compound annualized total shareholder return (*i.e.*, share price change plus dividends on a reinvested basis) during the applicable performance period.

The Company recorded \$468 and \$848, in compensation expenses related to the Performance-based Program during the three and six months ended June 30, 2014, respectively. The Company recorded \$237 and \$517 in compensation expenses related to the Performance-based Program during the three and six months ended June 30, 2013, respectively.

**Restricted Stock**

The following tables present the activities and balances related to restricted stock for the dates and periods indicated:

|   | Three Months Ended |          | Six Months Ended June |          |
|---|--------------------|----------|-----------------------|----------|
|   | June 30,<br>2014   | 2013     | 30,<br>2014           | 2013     |
| Shares granted                                    | 36,102             | 36,000   | 36,102                | 36,000   |
| Weight-average share price                        | \$ 27.70           | \$ 26.74 | \$ 27.70              | \$ 26.74 |
| Compensation expense recognized during the period | \$ 203             | \$ 100   | \$ 395                | \$ 209   |

|   | June 30, 2014 | December 31,<br>2013 |
|---|---------------|----------------------|
| Restricted Class A shares outstanding, unvested           | 77,109        | 57,673               |
| Unrecognized compensation cost related to unvested shares | \$1,443       | \$838                |
| Weighted-average vesting period remaining                 | 2.22 years    | 2.04 years           |

## **Conversion of Class B Common Stock to Class A Common Stock**

During the three months ended June 30, 2014, a holder of the Company's common stock converted an aggregate of 104,827 shares of Class B common stock into 104,827 shares of Class A common stock. Holders of shares of Class A common stock are entitled to one vote for each share on all matters voted on by shareholders, and the holders of shares of Class B common stock are entitled to three votes per share on all matters voted on by shareholders. Under the Company's Articles of Incorporation, shares of Class B common stock are convertible into shares of Class A common stock on a one-for-one basis.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Dollars in thousands, except per share data)  
(Unaudited)**

**8. Recent Accounting Pronouncements:**

On April 10, 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which changes the criteria for determining which disposals can be presented as discontinued operations and modifies related disclosure requirements. This standard will be effective for the Company on January 1, 2015, and the Company does not expect it to have a significant impact on the Company's financial statements upon implementation.

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU No. 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard will be effective for the Company on January 1, 2017. Early application is not permitted. The Company does not expect ASU No. 2014-09 to have a significant impact on the Company's financial statements upon implementation.

**9. Subsequent Events:**

On July 1, 2014, the Company granted Book Value PSUs and TSR PSUs to the participants in the Performance-based Program (2014 PSU Grants). For the 2014 PSU Grants, the Compensation Committee awarded PSUs with an aggregate grant date fair value equal to 100% of the awardee's base salary, with 50% of the total grant date fair value represented by Book Value PSUs and 50% of the total grant date fair value represented by TSR PSUs. The 2014 PSU Grants have a three-year performance period.

The actual number of shares of Class A common stock that will be issued to each participant at the end of the applicable performance period will vary between 0% and 250% of the number of PSUs granted, depending on performance results. If the threshold level of performance goals are not achieved, no PSUs are earned. Participants will earn 50% of the granted PSUs for Company performance at the threshold level, 100% of the granted PSUs for Company performance at the target level and 250% of the granted PSUs for Company performance at the maximum level, with linear interpolation for achievement falling between the performance levels.

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

Unless the context otherwise requires or provides, references in this Quarterly Report on Form 10-Q to we, us, our and our company refer to Arlington Asset Investment Corp. (Arlington Asset) and its subsidiaries. This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in Item 1 of this Quarterly Report on Form 10-Q, as well as our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013.

The discussion of our consolidated financial condition and results of operations below may contain forward-looking statements. These statements, which reflect management's beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect our future results, please see Cautionary Statement About Forward-Looking Statements immediately following Item 4 of Part I of this Quarterly Report on Form 10-Q and the risk factors included in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2013.

### **Our Company**

We are a principal investment firm that currently acquires and holds primarily mortgage-related assets. We acquire residential mortgage-backed securities (MBS), either issued by U.S. government agencies or guaranteed as to principal and interest by U.S. government agencies or U.S. government-sponsored entities (agency-backed MBS). We also acquire MBS issued by private organizations (private-label MBS), subject to maintaining our exemption from regulation as an investment company under the Investment Company Act of 1940, as amended (1940 Act). In the future, we may acquire and hold other types of assets, including commercial MBS, asset backed securities, other structured securities, commercial mortgage loans, commercial loans, residential mortgage loans, and other real estate-related loans and securities. In addition, we also may pursue other business activities that will utilize our experience in analyzing investment opportunities and applying similar portfolio management skills. We are a Virginia corporation and taxed as a C corporation for federal income tax purposes. We operate in the United States.

### **Factors that Affect our Results of Operations and Financial Condition**

Our business is materially affected by a variety of industry and economic factors, including:

- conditions in the global financial markets and economic conditions generally;
- changes in interest rates and prepayment rates;
- actions taken by the U.S. government, U.S. Federal Reserve and the U.S. Treasury;
- changes in laws and regulations and industry practices;
- actions taken by ratings agencies with respect to the U.S.'s credit rating; and
- other market developments.

Adverse market conditions and actions by governmental authorities could adversely affect our business in many ways, including but not limited to making it more difficult for us to analyze our investment portfolio, reducing the market value of our MBS portfolio, adversely affecting our ability to maintain targeted amounts of leverage on our MBS portfolio and successfully implement our hedging strategy, and limiting our ability to follow our current investment and financing strategies. While uncertain, these potentially adverse market conditions and actions by governmental

authorities may adversely affect our liquidity, financial position and results of operations. We have been evaluating, and will continue to evaluate, the potential impact of recent government actions, including developments relating to various state and federal government actions affecting the market price of MBS, related derivative securities, and interest rates. For further discussions on how market conditions and government actions may adversely affect our business, see Item 1A Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2013.

Our MBS portfolio is affected by general U.S. residential real estate market conditions and the overall U.S. economic environment. In particular, our MBS strategy and the performance of our MBS portfolio is

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influenced by the specific characteristics of these markets, including prepayment rates, credit losses, interest rates and the interest rate yield curve. Our results of operations with respect to our MBS portfolio primarily depend on, among other things, the level of our interest income, the amount and cost of borrowings we may obtain by pledging our investment portfolio as collateral for the borrowings and the cost and impact of our hedges. Our borrowing cost varies based on changes in interest rates and changes in the amount we can borrow, which is generally based on the fair value of the MBS portfolio and the advance rate the lenders are willing to lend against the collateral provided. We have entered into various hedging transactions to mitigate the interest rate sensitivity which directly impacts our cost of borrowing and the market value of our agency-backed MBS. The market value of these hedge instruments is expected to fluctuate inversely relative to the value of the agency-backed MBS portfolio and decrease in value during periods of declining interest rates and/or widening mortgage spreads. Conversely, during periods of increasing rates and/or tightening mortgage spreads, these instruments are expected to increase in value.

The payment of principal and interest on the agency-backed MBS that we acquire and hold is guaranteed by the Federal Home Loan Mortgage Corporation (Freddie Mac) or the Federal National Mortgage Association (Fannie Mae). The payment of principal and interest on agency-backed MBS issued by Freddie Mac or Fannie Mae is not guaranteed by the U.S. government. Any failure to honor its guarantee of agency-backed MBS by Freddie Mac or Fannie Mae or any downgrade of securities issued by Freddie Mac or Fannie Mae by the rating agencies could cause a significant decline in the value of and cash flow from any agency-backed MBS we own that are guaranteed by such entity.

## **Current Market Conditions and Trends**

The U.S. Federal Reserve continued its reductions of its monthly purchases of agency-backed MBS and U.S. Treasury bonds during the second quarter of 2014. These reductions are commonly referred to as tapering. As of July 2014, the Federal Reserve had reduced its purchases to \$20 billion of U.S. Treasury bonds and \$15 billion in agency-backed MBS per month. On July 30, 2014, the Federal Reserve announced that purchases would be further reduced to \$15 billion of U.S. Treasury bonds and \$10 billion in agency-backed MBS per month beginning in August 2014. In minutes from the U.S. Federal Reserve's Open Market Committee (FOMC) June 2014 meeting, the U.S. Federal Reserve indicated that it anticipates ending its bond buying program in October 2014. On June 18, 2014, the FOMC reiterated its continuing long-term goals of reaching maximum employment and inflation of 2% before adjusting the target Fed Funds Rate. The FOMC reiterated these sentiments on July 30, 2014, although it noted that the employment and inflation were moving closer to its objectives.

Given the low inflation projections, we believe that the U.S. government's monetary policy, including the timing of tapering asset purchases, will likely be dependent on actual growth in employment rather than inflation concerns. It is important to note that over the past several years, actual employment growth has been consistently below the U.S. Federal Reserve's projections. While there are signs of a recovery, uncertainty continues to dominate the market, due to the continued low interest rate environment and actions by the U.S. Federal Reserve. We believe the general business environment will continue to be challenging in 2014 and future periods. Our growth outlook is dependent, in part, on the strength of the financial markets, the impact of fiscal and monetary policy actions by the United States and other countries, the overall market value of U.S. equities and liquidity in the financial system. Depending on recent market developments and movements, we may seek to re-align our strategy and our portfolio. We will continue to closely monitor the developments in the market and evaluate the opportunities across the spectrum in the mortgage industry and other types of assets and seek the highest risk-adjusted returns for our capital.

We believe the limited liquidity and volatility in the credit markets will continue while the markets seek to determine the right equilibrium levels for benchmark interest rates as the U.S. Federal Reserve stimulus leaves the market place.



## **Recent Government Activity**

In June of 2013, Senators Bob Corker (R-TN) and Mark Warner (D-VA) introduced the Housing Finance Reform and Taxpayer Protection Act of 2013 (the Corker-Warner Bill) into the U.S. Senate. The proposed bill has served as a basis of discussion for congressional efforts to reform Fannie Mae and Freddie Mac.

GSE reform lost momentum in the second quarter of 2014 when the Johnson-Crapo Bill, which is closely based on the Corker-Warner Bill, failed to secure enough support to be considered by Congress even though it

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was approved by the Senate Banking Committee. The fate of the proposed legislation is unclear, as reports indicate that the U.S. House Republican leadership appears to favor a very different approach to reform. There is no way to know if this proposal will become law, how this proposal would impact housing finance, and what impact, if any, it would have on companies that invest in MBS. The passage of any new legislation affecting Fannie Mae and Freddie Mac may create market uncertainty and reduce the actual or perceived credit quality of securities issued or guaranteed by the U.S. government through a new or existing successor entity to Fannie Mae and Freddie Mac. If the charters of Fannie Mae and Freddie Mac were revoked, it is unclear what effect, if any, this would have on the value of the existing Fannie Mae and Freddie Mac agency-backed MBS. It is also possible that the above-referenced proposed legislation, if made law, could adversely impact the market for securities issued or guaranteed by the U.S. government and the spreads at which they trade. The foregoing could materially adversely affect the pricing, supply, liquidity and value of our target assets and otherwise materially adversely affect our business, operations and financial condition.

## **Executive Summary**

On June 11, 2014, the Company's Board of Directors appointed J. Rock Tonkel, Jr. as the Company's Chief Executive Officer effective immediately. Mr. Tonkel succeeds Eric F. Billings as Chief Executive Officer, who is retiring from this position in order to focus on his other business activities. Mr. Tonkel has served as President and Chief Operating Officer, a member of the Company's Board of Directors and a member of the Company's Investment Committee since 2007. Mr. Tonkel will also continue to serve as President of the Company, as a director and as a member of the Investment Committee. Mr. Billings will continue to serve as Executive Chairman of the Board as well as the Chairman of the Company's Investment Committee.

During the second quarter of 2014, markets continued to adjust to the Federal Reserve's tapering policy. The FOMC communicated that it was seeing an improvement in economic activity and labor market conditions. As a result, the FOMC continued its tapering program of reducing its monthly purchases of agency-backed MBS and U.S. Treasury securities. On June 18, 2014, the Federal Reserve announced that it planned to decrease its monthly purchases to \$20 billion of U.S. Treasury bonds and \$15 billion of agency-backed MBS per month beginning in July 2014. On July 30, 2014, the Federal Reserve announced that purchases would be further reduced to \$15 billion of U.S. Treasury bonds and \$10 billion in agency-backed MBS per month beginning in August 2014. Additionally, the FOMC has stated it would continue to reinvest principal payments from its holdings of these securities in agency-backed MBS and rolling over maturing U.S. Treasury securities at auction.

Actions taken by the Federal Reserve so far in 2014 have been in line with market expectations. In recent months, growth in economic activity has rebounded and labor market indicators generally showed further improvement. The unemployment rate, though lower, remains elevated relative to pre-recession levels. Household spending appears to be rising moderately and business fixed investment resumed its advance, while the recovery in the housing sector remained slow. We believe that fiscal policy is restraining economic growth, although the extent of this restraint is diminishing. Inflation has been running below the FOMC's longer-run objective, but longer-term inflation expectations have remained stable.

During the second quarter of 2014, yields have continued to fall and the yield curve has flattened since December 31, 2013. The 10-year Treasury decreased 21 basis points and the 5-year to 10-year Treasury curve flattened by 10 basis points. In addition, the spread between agency-backed MBS and interest rate swaps tightened during the quarter ended June 30, 2014, with the spread between Fannie Mae 30-year par priced securities and 5-year interest rate swaps tightening approximately 16 basis points.

Based on current economic indicators and trends in underlying credit and housing data, we continue to review the allocation of our available capital in an effort to maximize return to our shareholders. As of June 30, 2014, our MBS portfolio consisted of \$3.1 billion in fair value, with \$2.8 billion of agency-backed MBS and \$0.3 billion of private-label MBS. Our combined MBS portfolio performed in line with our expectations in the second quarter of 2014. Our private-label MBS portfolio value increased due to continued demand for these assets and the continued improvement in their credit metrics. The agency-backed MBS values increased during the second quarter of 2014 due to lower rates and tighter spreads. This resulted in an incremental increase in the performance of our assets when compared to the change in value of the hedges that we have against this portfolio. Our hedge design and structure is intended to offset substantially the change in value of our assets due to changes in interest rates. Other factors, such as the steepness or flatness of the yield curve, will potentially have an effect on the value of our hedges as compared to the assets.

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For the three months ended June 30, 2014, we had net income of \$18.8 million, or \$0.94 per share (diluted). As of June 30, 2014, our book value per share was \$31.51.

In addition to the financial results reported in accordance with generally accepted accounting principles as consistently applied in the United States (GAAP), we calculated non-GAAP core operating income for the three and six months ended June 30, 2014. Our non-GAAP core operating income for the three and six months ended June 30, 2014 was \$24.4 million and \$44.5 million, respectively. In determining core operating income, we excluded certain legacy litigation expenses and the following non-cash expenses: (1) compensation costs associated with stock-based awards, (2) accretion of MBS purchase discounts adjusted for contractual interest and principal repayments in excess of proportionate invested capital, (3) other-than-temporary impairment charges recognized, (4) non-cash income tax provisions, and (5) benefit from the reversal of previously accrued federal and state tax liability and accrued interest related to uncertain tax positions. Additionally, starting in 2014, the Company has excluded both realized and unrealized gains and losses on the agency-backed MBS and all related hedge instruments, and has presented prior periods on a consistent basis. These adjustments are only for the purpose of calculating our non-GAAP core operating income; therefore, they do not change our GAAP book value as reported.

The Company's portfolio strategy on the agency-backed MBS portfolio is to generate a net interest margin on the leveraged assets and hedge the market value of the assets, expecting that the fluctuations in the market value of the agency-backed MBS and related hedges should largely offset each other over time. As a result, the Company excludes both the realized and unrealized fluctuations in the gains and losses in the assets and hedges on its hedged, agency-backed MBS portfolio, when assessing the underlying core operating income of the Company. However, the Company's portfolio strategy on the private-label MBS is to generate a total cash return comprised of both interest income and the cash return realized when the private-label MBS are sold which equals the difference between the sale price and the discount to par paid at acquisition. Therefore, the Company excludes non-cash accretion of private-label MBS purchase discounts from core operating income, but includes realized cash gains or losses on its private-label MBS portfolio in core operating income to reflect the total cash return on those securities over their holding period.

This non-GAAP core operating income measurement is used by management to analyze and assess the Company's operating results on its portfolio and assist with the determination of the appropriate level of dividends. We believe that this non-GAAP measurement assists investors in understanding the impact of these non-core items and non-cash expenses on our performance and provides additional clarity around our earnings capacity and trends. A limitation of utilizing this non-GAAP measure is that the GAAP accounting effects of these events do in fact reflect the underlying financial results of our business and these effects should not be ignored in evaluating and analyzing our financial results. Therefore, we believe net income on a GAAP basis and core operating income on a non-GAAP basis should be considered together.

The following is a reconciliation of GAAP net income to non-GAAP core operating income for the three and six months ended June 30, 2014 and 2013 (dollars in thousands):

|                   | Three Months Ended June 30, |         |                        |
|-------------------|-----------------------------|---------|------------------------|
|                   | 2014                        | 2013    | 2013                   |
|                   |                             | Revised | As Previously Reported |
| GAAP net income   | \$18,839                    | \$3,194 | \$3,194                |
| Adjustments       |                             |         |                        |
| Adjusted expenses |                             |         | 2,371                  |

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|  |          |          |          |
|--|----------|----------|----------|
| Legacy litigation expenses <sup>(1)</sup>                                      | 43       | 293      |          |
| Non-cash income tax provisions   | 11,782   | 2,078    |          |
| Stock compensation   | 779      | 442      | 442      |
| Non-cash interest income related to purchase discount accretion <sup>(2)</sup> | (3,934 ) | (464 )   | (464 )   |
| Net realized and unrealized (gain) loss on trading MBS and hedge instruments   | (3,199 ) | 17,569   | 12,584   |
| Other-than-temporary impairment charges  | 80       | 728      | 728      |
| Non-GAAP core operating income   | \$24,390 | \$23,840 | \$18,855 |

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|   | Six Months Ended June 30, |                 |                                      |
|---|---------------------------|-----------------|--------------------------------------|
|   | 2014                      | 2013<br>Revised | 2013<br>As<br>Previously<br>Reported |
| GAAP net income   | \$25,872                  | \$6,371         | \$6,371                              |
| Adjustments   |                           |                 |                                      |
| Adjusted expenses   |                           |                 | 2,872                                |
| Legacy litigation expenses <sup>(1)</sup>   | 54                        | 576             |                                      |
| Non-cash income tax provisions  | 15,986                    | 2,299           |                                      |
| Stock compensation  | 1,456                     | 937             | 940                                  |
| Non-cash interest income related to purchase discount accretion <sup>(2)</sup>                            | (6,378 )                  | (1,176 )        | (1,176 )                             |
| Net realized and unrealized loss on trading MBS and hedge instruments                                     | 7,434                     | 32,353          | 27,322                               |
| Benefit from the reversal of federal tax liability and accrued interest related to uncertain tax position |                           | (3,744 )        | (3,744 )                             |
| Other-than-temporary impairment charges   | 80                        | 890             | 890                                  |
| Non-GAAP core operating income  | \$44,504                  | \$38,506        | \$33,475                             |

Legacy litigation expenses relate to legal matters pertaining to events related to business activities the Company (1) completed or exited in or prior to 2009 primarily debt extinguishment, sub-prime mortgage origination and securitization and broker/dealer operations.

Non-cash interest income related to purchase discount accretion represents interest income recognized in excess of (2) cash receipts related to contractual interest income and principal repayments in excess of proportionate invested capital.

As of June 30, 2014, our agency-backed MBS consisted of \$2.6 billion in face value with a cost basis and fair value of \$2.8 billion. Our agency-backed MBS had a weighted-average coupon of 4.04% and a weighted-average cost of funding of 0.32% at June 30, 2014. There were no sales of our agency-backed MBS during the three and six months ended June 30, 2014.

We have entered into various hedge instruments, which are described below, to mitigate the interest rate sensitivity which directly impacts our cost of borrowing and the market value of our agency-backed MBS. The Eurodollar futures mature through December 31, 2018 and have a lifetime weighted-average rate of 2.63%, as compared to a lifetime weighted-average market rate of 1.93% as of June 30, 2014. The swap futures traded on the Chicago Board of Trade Exchange mature in September 2014 and have a weighted-average rate of 2.81%, as compared to a weighted-average market rate of 2.71% as of June 30, 2014. The swap futures traded on the Eris Exchange have a stated maturity of March 2024 and have a weighted-average rate of 3.15%, as compared to a weighted-average market rate of 2.59% as of June 30, 2014. The value of these hedge instruments is expected to fluctuate inversely relative to the change in value of the agency-backed MBS portfolio and decrease in value during periods of declining interest rates and/or widening mortgage spreads. Conversely, during periods of increasing interest rates and/or tightening mortgage spreads, these instruments are expected to increase in value.

As of June 30, 2014, our private-label MBS portfolio consisted of \$423.9 million in face value with an amortized cost basis of \$256.4 million and had a fair value at \$314.1 million. The unamortized net discount on our private-label MBS portfolio was \$167.5 million as of June 30, 2014. During the three months ended June 30, 2014, we recognized net interest income of \$6.6 million, representing a 10.0% annualized yield, including coupon and accretion of purchase

discount based on the current accretable yield rate, from our private-label MBS portfolio. During the three months ended June 30, 2014, we received proceeds of \$21.5 million from the sale of \$28.2 million in face value of our private-label MBS, realizing \$4.7 million in gains. We also recognized \$0.1 million in other-than-temporary impairment (OTTI) charges during the three months ended June 30, 2014. OTTI charges do not affect non-GAAP core operating income or book value, but does reduce our net income and lowers the accounting basis used to record future discount accretion.

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Our remaining private-label MBS are re-REMIC tranches in securitization trusts issued between 2005 and 2010. The re-REMIC securities represent interests in re-securitizations of senior MBS and pro-rata mezzanine securities. For re-REMIC securities, the cash flows from, and any credit losses absorbed by, the underlying MBS are allocated among the re-REMIC securities issued in the re-securitization transactions based on the re-REMIC structure. For example, prime and non-prime residential senior securities have been resecured to create a two-tranche structure with a re-REMIC senior security and a re-REMIC subordinated security. In these re-REMIC securities, all principal payments from the underlying securities are directed to the re-REMIC senior security until the face value is fully paid off. Thereafter, all principal payments are directed to the re-REMIC subordinated security. For pro-rata mezzanine securities, principal payments from the underlying MBS are typically allocated concurrently and proportionally to the mezzanine securities along with senior securities. The re-REMIC subordinated and mezzanine securities absorb credit losses, if any, first; however, these credit losses occur only when credit losses exceed the credit protection provided to the underlying securities. Re-REMIC and mezzanine securities receive interest while any face value is outstanding. Our private-label MBS have approximately 0.3% credit enhancement on a weighted-average basis, which, in addition to our purchase discount, provides protection to our invested capital.

We generally purchased the private-label MBS at a discount to face value. We estimate, at least on a quarterly basis, the future expected cash flows based on our observation and assessment of current information and events and by applying a number of assumptions related to prepayment rates, interest rates, default rates, loss severity rates and the timing and amount of cash flows and credit losses. These assumptions, which are disclosed in note 2 to our financial statements, are difficult to predict as they are subject to uncertainties and contingencies related to future events that may impact our estimates and interest income.

Our interest income includes the contractual coupon payments and amortization of purchase premiums and accretion of discounts, if any, on our available-for-sale MBS portfolio and contractual coupon payments on our trading MBS portfolio. Purchase premiums or discounts, if any, on our trading MBS portfolio are accounted for under mark-to-market accounting and the changes in value are recorded in investment gain (loss), net, on the statement of comprehensive income.

Interest income on the private-label MBS that were purchased at a discount to face value is recognized based on the security's expected effective interest rate. At acquisition, the accretable yield is calculated as the difference between the undiscounted expected cash flows and the purchase price which is expected to be accreted into interest income over the remaining life of the security on a level-yield basis. The difference between the contractually required payments and the undiscounted expected cash flows represents the non-accretable difference. Based on actual payment activities and changes in estimates of undiscounted expected future cash flows, the accretable yield and the non-accretable difference can change over time. Significant increases in the amount or timing of undiscounted expected future cash flows are recognized prospectively as an adjustment to the accretable yield. As a result, we may recognize higher non-cash interest income over the security's holding period and may not realize the level of interest income recognized using the higher accretion rates. In addition, we may be subject to more frequent and higher non-cash OTTI charges than actual losses realized on the security as a result.

We evaluate available-for-sale securities for OTTI charges at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In general, when the fair value of an available-for-sale security is less than its amortized cost at the reporting date, the security is considered impaired. In evaluating these available-for-sale securities for OTTI charges, consideration is given to (1) the length of time and the extent to which the fair value has been lower than carrying value, (2) the severity of the decline in fair value, (3) the financial condition and near-term prospects of the issuer, (4) our intent to sell, and (5) whether it is more-likely-than-not we would be required to sell the security before anticipated recovery.



For available-for-sale, agency-backed MBS, if it is determined that the impairment is other-than-temporary, then the amount that the fair value is below its amortized cost basis is recorded as an impairment charge and recorded through earnings. For unrealized losses that are determined to be temporary, a further evaluation is performed to determine the credit portion of the OTTI and the credit portion is recorded through our statement of comprehensive income.

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For available-for-sale, private-label MBS securities that have been acquired at discounts to face value due in part to credit deterioration since origination, we re-evaluate the undiscounted expected future cash flows and the changes in cash flows from those originally projected at the time of purchase or when last revised. The discount rate used to calculate the present value of expected future cash flows is the current yield used for income recognition purposes as compared to the discount rate used to calculate the fair value of the investment security is the current expected market rate. For those securities in an unrealized loss position, the difference between the carrying value and the net present value of expected future cash flows is recorded as OTTI charges through our statement of comprehensive income.

Continued expectations of stabilization and improvement in the housing market, increased liquidity and available leverage have stabilized prices for our private-label MBS, particularly among re-REMIC mezzanine securities. Our re-REMIC securities are predominantly held in the subordinate tranches. We will continue to closely monitor the performance of these securities.

We have been evaluating, and will continue to evaluate, the opportunities across the MBS industry and seek the highest risk-adjusted returns for our capital, and to strengthen our position and to maximize return to our shareholders. We evaluated and prioritized the risk-adjusted return we expect to receive on every asset based upon a current cash yield perspective as well as from a total yield perspective that includes expected reflation, which is defined as an increase in value between the amortized cost basis and the par value of the security. Historically, based on market conditions, we believe our MBS assets have provided us with higher relative risk-adjusted rates of return than most other portfolio opportunities we have evaluated. We intend to continue to evaluate acquisition opportunities against the returns available in each of our asset alternatives and endeavor to allocate our assets and capital with an emphasis toward what we believe will generate the highest risk-adjusted return available. This strategy may cause us to have different allocations of capital in different environments. We believe we have constructed an MBS portfolio with attractive characteristics and will continue to monitor relative value between the various classes of MBS and may re-allocate our portfolio at any time based on management's view of the market. We also believe the strategy of maintaining our combined portfolio, agency-backed MBS and private-label MBS, allows us to mitigate risk exposures in a sometimes unexpected and volatile environment.

The following is a summary of our net income for the periods indicated (dollars in thousands):

|                                | Three Months Ended |           | Six Months Ended June |           |
|--------------------------------|--------------------|-----------|-----------------------|-----------|
|                                | June 30,           |           | 30,                   |           |
|                                | 2014               | 2013      | 2014                  | 2013      |
| Net interest income            | \$ 27,387          | \$ 20,925 | \$ 48,969             | \$ 37,649 |
| Other income (loss), net       | 7,906              | (11,257 ) | 1,992                 | (24,790 ) |
| Other expenses                 | 4,380              | 3,920     | 8,535                 | 7,696     |
| Income before income taxes     | 30,913             | 5,748     | 42,426                | 5,163     |
| Income tax provision (benefit) | 12,074             | 2,554     | 16,554                | (1,208 )  |
| Net income                     | \$ 18,839          | \$ 3,194  | \$ 25,872             | \$ 6,371  |

For the three months ended June 30, 2014, our net income was \$18.8 million compared to net income of \$3.2 million for the three months ended June 30, 2013. Our net income includes net interest income of \$27.4 million and other net income of \$7.9 million for the three months ended June 30, 2014 compared to net interest income of \$20.9 million and other net loss of \$11.3 million for the three months ended June 30, 2013. The increase in net interest income is due primarily to an increase in the average balance of our agency-backed MBS portfolio. The increase in other net income is discussed below. Our other expenses increased to \$4.4 million during the three months ended June 30, 2014 compared to \$3.9 million for the three months ended June 30, 2013, primarily as a result of increases in compensation expenses offset by a decrease in legal expenses.

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For the six months ended June 30, 2014, our net income was \$25.9 million compared to net income of \$6.4 million for the six months ended June 30, 2013. Our net income includes net interest income of \$49.0 million and other net income of \$2.0 million for the six months ended June 30, 2014 compared to net interest income of \$37.6 million and other net loss of \$24.8 million for the six months ended June 30, 2013. The increase in net interest income is due primarily to an increase in the average balance of our

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agency-backed MBS portfolio. The increase in other net income is discussed below. Our other expenses increased to \$8.5 million during the six months ended June 30, 2014 compared to \$7.7 million during the six months ended June 30, 2013 primarily as a result of increases in compensation expenses offset by a decrease in legal expenses.

## Principal Investing Portfolio

The following table summarizes our principal investing portfolio including principal receivable on MBS as of June 30, 2014 (dollars in thousands):

|                               | Face<br>Amount | Fair Value   |
|-------------------------------|----------------|--------------|
| Trading                       |                |              |
| Agency-backed MBS             |                |              |
| Fannie Mae                    | \$ 1,558,540   | \$ 1,661,538 |
| Freddie Mac                   | 1,085,187      | 1,152,445    |
| Available-for-sale            |                |              |
| Agency-backed MBS             |                |              |
| Fannie Mae                    | 37             | 41           |
| Private-label MBS             |                |              |
| Senior securities             |                |              |
| Re-REMIC securities           | 423,880        | 314,148      |
| Other mortgage related assets | 69,682         | 237          |
| Total                         | \$ 3,137,326   | \$ 3,128,409 |

## Operating Income

Our operating income consists primarily of net interest income, net investment gains and losses, and investment fund earnings.

## Expenses

Interest expense includes the costs of our repurchase agreement borrowings and long-term debt securities.

Compensation and benefits expense includes base salaries as well as incentive compensation. Salaries, payroll taxes and employee benefits are relatively fixed in nature. In addition, compensation and benefits expense includes estimated performance-based incentive compensation, including the discretionary component that is more likely-than not to be paid and non-cash expenses associated with all stock-based awards granted to employees.

Professional services expense includes accounting, legal and consulting fees. Many of these expenses, such as legal fees, are to a large extent variable related to level of transactions, ongoing litigation and initiatives.

Business development expense includes primarily travel and entertainment expenses.

Occupancy and equipment expense includes rental costs for our facilities and depreciation and amortization of equipment and software. These expenses are largely fixed in nature.

Communications expenses include voice, data and internet service fees, and data processing costs.

Other operating expenses include professional liability and property insurance, directors' fees including cash and stock awards, printing and copying, business licenses and taxes, office supplies, penalties and fees, charitable contributions and other miscellaneous office expenses, if any.

TABLE OF CONTENTS**Results of Operations****Three months ended June 30, 2014 compared to three months ended June 30, 2013**

We reported net income of \$18.8 million for the three months ended June 30, 2014 compared to net income of \$3.2 million for the three months ended June 30, 2013 which included the following results for the periods indicated (dollars in thousands):

|                                | Three Months Ended June 30, |           |
|--------------------------------|-----------------------------|-----------|
|                                | 2014                        | 2013      |
| Interest income                | \$ 30,063                   | \$ 23,145 |
| Interest expense               | 2,676                       | 2,220     |
| Net interest income            | 27,387                      | 20,925    |
| Other income (loss), net       |                             |           |
| Investment gain (loss), net    | 7,910                       | (11,253 ) |
| Other loss                     | (4 )                        | (4 )      |
| Total other income (loss), net | 7,906                       | (11,257 ) |
| Other expenses                 | 4,380                       | 3,920     |
| Income before income taxes     | 30,913                      | 5,748     |
| Income tax provision           | 12,074                      | 2,554     |
| Net income                     | \$ 18,839                   | \$ 3,194  |

Net income increased \$15.6 million from net income of \$3.2 million for the three months ended June 30, 2013 to net income of \$18.8 million for the three months ended June 30, 2014. The increase in net income is due to the following changes:

**Net Interest Income**

Net interest income increased \$6.5 million (31.1%) from \$20.9 million for the three months ended June 30, 2013 to \$27.4 million for the three months ended June 30, 2014. The increase is primarily the result of fully deploying our investable capital generated from the capital raised from our public offerings in 2014 and 2013 on a leveraged basis to our MBS portfolio. See additional yield analysis below. The components of income from our principal investment activities, net of related interest expense are as follows (dollars in thousands):

|                             | Three Months Ended June 30, |           |
|-----------------------------|-----------------------------|-----------|
|                             | 2014                        | 2013      |
| Net interest income         | \$ 27,939                   | \$ 21,331 |
| Investment gain (loss), net | 7,910                       | (11,253 ) |

The components of net interest income from our MBS related portfolio is summarized in the following table (dollars in thousands):

Three Months Ended June 30,

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|                            | 2014               |                     |                 | 2013               |                     |                 |
|----------------------------|--------------------|---------------------|-----------------|--------------------|---------------------|-----------------|
|                            | Average<br>Balance | Income<br>(Expense) | Yield<br>(Cost) | Average<br>Balance | Income<br>(Expense) | Yield<br>(Cost) |
| Agency-backed MBS          | \$2,450,773        | \$23,184            | 3.78 %          | \$1,750,089        | \$16,522            | 3.78 %          |
| Private-label MBS          |                    |                     |                 |                    |                     |                 |
| Senior securities          |                    |                     |                 | 5,452              | 224                 | 16.41 %         |
| Re-REMIC securities        | 263,866            | 6,852               | 10.39 %         | 240,886            | 6,386               | 10.60 %         |
| Other investments          | 274                | 7                   | 10.27 %         | 437                | 12                  | 10.90 %         |
|                            | \$2,714,913        | 30,043              | 4.43 %          | \$1,996,864        | 23,144              | 4.64 %          |
| Other <sup>(1)</sup>       |                    | 20                  |                 |                    | 1                   |                 |
|                            |                    | 30,063              |                 |                    | 23,145              |                 |
| Repurchase agreements      | \$2,300,868        | (2,124 )            | (0.37 )%        | \$1,660,108        | (1,814 )            | (0.43 )%        |
| Net interest income/spread |                    | \$27,939            | 4.06 %          |                    | \$21,331            | 4.21 %          |

(1) Includes interest income on cash and other miscellaneous interest-earning assets.

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The increase in net interest income of \$6.6 million from \$21.3 million from the three months ended June 30, 2013 to \$27.9 million for the three months ended June 30, 2014 is primarily due to the increase in our agency-backed MBS portfolio from the deployment of capital raised from our public offerings during 2014 and 2013 on a leveraged basis. The decreases in interest rates in the MBS portfolio and related repurchase agreements did not materially impact the change in net interest income for the three months ended June 30, 2014 from the three months ended June 30, 2013.

Interest income from other investments represents interest on interest-only MBS.

The effects of changes in the composition of our investments on our net interest income from our principal investment activities are summarized below (dollars in thousands):

|                         | Three Months Ended June 30, 2014<br>vs.<br>Three Months Ended June 30, 2013 |                       |              |
|-------------------------|---|-----------------------|--------------|
|                         | Rate <sup>(1)</sup>   | Volume <sup>(1)</sup> | Total Change |
| MBS                     |   |                       |              |
| Agency-backed MBS       | \$ 33   | \$ 6,629              | \$ 6,662     |
| Private-label MBS       |   |                       |              |
| Senior securities       | (112 )  | (112 )                | (224 )       |
| Re-REMIC securities     | (133 )  | 599                   | 466          |
| Total private-label MBS | (245 )  | 487                   | 242          |
| Total MBS               | (212 )  | 7,116                 | 6,904        |
| Other interest          |   | 14                    | 14           |
| Repurchase agreements   | 267   | (577 )                | (310 )       |
|                         | \$ 55   | \$ 6,553              | \$ 6,608     |

<sup>(1)</sup> The change in interest income and interest expense due to both rate and volume has been allocated to rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each.

Interest expense related to repurchase agreements increased \$0.3 million (16.7%) to \$2.1 million for the three months ended June 30, 2014 from \$1.8 million for the three months ended June 30, 2013 due to the increase in the repurchase agreement borrowings. Our repurchase borrowings increased primarily as a result of leveraging the net proceeds raised from our public offerings in 2014 and 2013 in connection with the investment of such net proceeds. Interest expense unrelated to our principal investing activity relates to long-term debt. These costs increased to \$0.6 million for the three months ended June 30, 2014 from \$0.4 million for the three months ended June 30, 2013 due to the increase in long-term debt outstanding.

**Other Income (Loss), Net**

Total other income (loss), net, increased \$19.2 million from a loss of \$11.3 million for the three months ended June 30, 2013 to income of \$7.9 million for the three months ended June 30, 2014 primarily due to an increase in net investment gains as follows (dollars in thousands):

|   | Three Months Ended June<br>30, |          |
|---|--------------------------------|----------|
|   | 2014                           | 2013     |
| Realized gains on sale of available-for-sale investments, net | \$ 4,690                       | \$ 6,928 |
| Available-for-sale and cost method securities OTTI charges    | (80 )                          | (728 )   |

Other Income (Loss), Net



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|   |           |              |
|---|-----------|--------------|
| Gains (losses) on trading investments, net      | 49,694    | (75,416 )    |
| (Losses) gains from derivative instruments, net | (46,585 ) | 57,776       |
| Other, net                                      | 191       | 187          |
| Investment gain (loss), net                     | \$ 7,910  | \$ (11,253 ) |

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The realized gains on sale of available-for-sale investments, net, recognized for the three months ended June 30, 2014 and 2013 were primarily the result of \$21.5 million and \$23.0 million of proceeds received, respectively, from the sales of \$28.2 million and \$25.4 million in face value of available-for-sale MBS, respectively. We recorded a gain of \$4.7 million and \$6.9 million from these sales for the three months ended June 30, 2014 and 2013, respectively.

We recorded OTTI charges of \$0.1 million and \$0.7 million for the three months ended June 30, 2014 and 2013 respectively, on available-for-sale, private-label MBS, with a cost basis of \$2.2 million and \$1.3 million, respectively, prior to recognizing the OTTI charges. The OTTI charges represent the difference between the carrying value and the net present value of expected future cash flows discounted using the current yield used for income recognition purposes, as compared to fair value which is discounted using the current expected market rate in accordance with GAAP for the securities acquired at discount due to credit deterioration since origination. These OTTI charges do not represent additional credit deterioration but the change in timing of cash flow projection primarily due to higher than projected actual cash flows during the earlier periods. For the three months ended June 30, 2014, we recorded OTTI charges of \$29.3 thousand on an investment in agency interest-only MBS. We recorded no OTTI charges on agency interest-only MBS for the three months ended June 30, 2013.

The gains on trading investments, net, recognized for the three months ended June 30, 2014 were primarily the result of net mark-to-market gain adjustments of \$49.7 million. There were no sales of trading investments for the three months ended June 30, 2014. The losses on trading investments, net, recognized for the three months ended June 30, 2013 were primarily the result of net mark-to-market loss adjustments of \$74.3 million and net losses of \$1.1 million from sales of trading investments. The securities sold during the three months ended June 30, 2013 had \$0.2 million in net cumulative gains from the acquisition price.

The losses from derivative instruments recognized for the three months ended June 30, 2014 were the result of net realized losses of \$9.0 million and net unrealized mark-to-market loss adjustments of \$37.6 million. The derivative instruments closed during the three months ended June 30, 2014 had \$10.2 million in net cumulative losses from the acquisition price. Gains from derivative instruments recognized for the three months ended June 30, 2013 were the result of net realized gains of \$2.7 million and net unrealized mark-to-market gain adjustments of \$55.1 million. The derivative instruments closed during the three months ended June 30, 2013 had \$5.2 million in net cumulative losses from the acquisition price. The value of our hedge instruments is expected to fluctuate inversely relative to the change in value of the agency-backed MBS portfolio.

### **Other Expenses**

Other expenses increased to \$4.4 million for the three months ended June 30, 2014 compared to other expenses of \$3.9 million for the three months ended June 30, 2013. The increase is primarily a result of increases in compensation expenses offset by a decrease in legal expenses.

### **Income Tax Provision (Benefit)**

Total income tax provision increased from \$2.6 million for the three months ended June 30, 2013 to \$12.1 million for the three months ended June 30, 2014. The increase in income tax provision was due primarily to an increase in pre-tax income. The net deferred tax assets, which are partially offset by a valuation allowance, include NOLs, which are available to offset the current and future taxable income. We recorded an expected tax liability for the period due to being subject to alternative minimum tax.



TABLE OF CONTENTS**Six months ended June 30, 2014 compared to six months ended June 30, 2013**

We reported net income of \$25.9 million for the six months ended June 30, 2014 compared to net income of \$6.4 million for the six months ended June 30, 2013 which included the following results for the periods indicated (dollars in thousands):

|                                | Six Months Ended June 30, |           |
|--------------------------------|---------------------------|-----------|
|                                | 2014                      | 2013      |
| Interest income                | \$ 53,930                 | \$ 41,473 |
| Interest expense               | 4,961                     | 3,824     |
| Net interest income            | 48,969                    | 37,649    |
| Other income (loss), net       |                           |           |
| Investment gain (loss), net    | 1,999                     | (24,782 ) |
| Other loss                     | (7 )                      | (8 )      |
| Total other income (loss), net | 1,992                     | (24,790 ) |
| Other expenses                 | 8,535                     | 7,696     |
| Income before income taxes     | 42,426                    | 5,163     |
| Income tax provision (benefit) | 16,554                    | (1,208 )  |
| Net income                     | \$ 25,872                 | \$ 6,371  |

Net income increased \$19.5 million from net income of \$6.4 million for the six months ended June 30, 2013 to net income of \$25.9 million for the six months ended June 30, 2014. The increase in net income is due to the following changes:

**Net Interest Income**

Net interest income increased \$11.4 million (30.3%) from \$37.6 million for the six months ended June 30, 2013 to \$49.0 million for the six months ended June 30, 2014. The increase is primarily the result of fully deploying our investable capital generated from the capital raised from our public offerings in 2014 and 2013 on a leveraged basis to our MBS portfolio. See additional yield analysis below. The components of income from our principal investment activities, net of related interest expense are as follows (dollars in thousands):

|                             | Six Months Ended June 30, |           |
|-----------------------------|---------------------------|-----------|
|                             | 2014                      | 2013      |
| Net interest income         | \$ 50,072                 | \$ 38,170 |
| Investment gain (loss), net | 1,999                     | (24,782 ) |

The components of net interest income from our MBS related portfolio is summarized in the following table (dollars in thousands):

| Six Months Ended June 30, |                  |              | Six Months Ended June 30, |                  |              |
|---------------------------|------------------|--------------|---------------------------|------------------|--------------|
| 2014                      |                  |              | 2013                      |                  |              |
| Average Balance           | Income (Expense) | Yield (Cost) | Average Balance           | Income (Expense) | Yield (Cost) |

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|                            |             |          |          |             |          |          |
|----------------------------|-------------|----------|----------|-------------|----------|----------|
| Agency-backed MBS          | \$2,111,619 | \$39,892 | 3.78 %   | \$1,539,270 | \$29,128 | 3.78 %   |
| Private-label MBS          |             |          |          |             |          |          |
| Senior securities          | 2,731       | 226      | 16.55 %  | 5,510       | 452      | 16.39 %  |
| Re-REMIC securities        | 268,960     | 13,776   | 10.24 %  | 210,079     | 11,867   | 11.30 %  |
| Other investments          | 289         | 15       | 10.34 %  | 451         | 25       | 10.93 %  |
|                            | \$2,383,599 | 53,909   | 4.52 %   | \$1,755,310 | 41,472   | 4.73 %   |
| Other <sup>(1)</sup>       |             | 21       |          |             | 1        |          |
|                            |             | 53,930   |          |             | 41,473   |          |
| Repurchase agreements      | \$1,990,904 | (3,858 ) | (0.39 )% | \$1,466,485 | (3,303 ) | (0.45 )% |
| Net interest income/spread |             | \$50,072 | 4.13 %   |             | \$38,170 | 4.28 %   |

(1) Includes interest income on cash and other miscellaneous interest-earning assets.

The increase in net interest income of \$11.9 million from \$38.2 million from the six months ended June 30, 2013 to \$50.1 million from the six months ended June 30, 2014 is primarily due to the increase in

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our agency-backed MBS portfolio from the deployment of capital raised from our public offerings during 2014 and 2013 on a leveraged basis. The decreases in interest rates in the MBS portfolio and related repurchase agreements did not materially impact the change in net interest income for the six months ended June 30, 2014 from the six months ended June 30, 2013. Interest income from other investments represents interest on interest-only MBS securities.

The effects of changes in the composition of our investments on our net interest income from our principal investment activities are summarized below (dollars in thousands):

|                         | Six Months Ended June 30, 2014 |                       |              |
|-------------------------|--------------------------------|-----------------------|--------------|
|                         | vs.                            |                       |              |
|                         | Six Months Ended June 30, 2013 |                       |              |
|                         | Rate <sup>(1)</sup>            | Volume <sup>(1)</sup> | Total Change |
| MBS                     |                                |                       |              |
| Agency-backed MBS       | \$ (48 )                       | \$ 10,812             | \$ 10,764    |
| Private-label MBS       |                                |                       |              |
| Senior securities       | 4                              | (230 )                | (226 )       |
| Re-REMIC securities     | (1,184 )                       | 3,093                 | 1,909        |
| Total private-label MBS | (1,180 )                       | 2,863                 | 1,683        |
| Total MBS               | (1,228 )                       | 13,675                | 12,447       |
| Other interest          |                                | 10                    | 10           |
| Repurchase agreements   | 509                            | (1,064 )              | (555 )       |
|                         | \$ (719 )                      | \$ 12,621             | \$ 11,902    |

<sup>(1)</sup> The change in interest income and interest expense due to both rate and volume has been allocated to rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each. Interest expense related to repurchase agreements increased \$0.6 million (18.2%) to \$3.9 million for the six months ended June 30, 2014 from \$3.3 million for the six months ended June 30, 2013 due to the increase in the repurchase agreement borrowings. Our repurchase borrowings increased primarily as a result of leveraging the net proceeds raised from our public offerings in 2014 and 2013 in connection with the investment of such net proceeds. Interest expense unrelated to our principal investing activity relates to long-term debt. These costs increased to \$1.1 million for the six months ended June 30, 2014 from \$0.5 million for the six months ended June 30, 2013 due to the increase in long-term debt outstanding.

**Other Income (Loss), Net**

Total other income (loss), net, increased \$26.8 million from a loss of \$24.8 million for the six months ended June 30, 2013 to income of \$2.0 million for the six months ended June 30, 2014 primarily due to an increase in net investment gains as follows (dollars in thousands):

|   | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2014                      | 2013      |
| Realized gains on sale of available-for-sale investments, net | \$ 9,359                  | \$ 8,489  |
| Available-for-sale and cost method securities OTTI charges    | (80 )                     | (890 )    |
| Gains (losses) on trading investments, net                    | 62,454                    | (91,524 ) |
| (Losses) gains from derivative instruments, net               | (70,065 )                 | 59,034    |
| Other, net  | 331                       | 109       |

Other Income (Loss), Net

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Investment gain (loss), net \$ 1,999 \$ (24,782 )

The realized gains on sale of available-for-sale investments, net, recognized for the six months ended June 30, 2014 and 2013 were primarily the result of \$37.2 million and \$27.8 million of proceeds received, respectively, from the sales of \$49.6 million and \$33.1 million in face value of available-for-sale MBS, respectively. We recorded a gain of \$9.4 million and \$8.5 million from these sales for the six months ended June 30, 2014 and 2013, respectively.

We recorded OTTI charges of \$0.1 million and \$0.9 million for the six months ended June 30, 2014 and 2013 respectively, on available-for-sale, private-label MBS, with a cost basis of \$2.2 million and \$1.6 million,

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respectively, prior to recognizing the OTTI charges. The OTTI charges represent the difference between the carrying value and the net present value of expected future cash flows discounted using the current yield used for income recognition purposes, as compared to fair value which is discounted using the current expected market rate in accordance with GAAP for the securities acquired at discount due to credit deterioration since origination. These OTTI charges do not represent additional credit deterioration but the change in timing of cash flow projection primarily due to higher than projected actual cash flows during the earlier periods. For the six months ended June 30, 2014, we recorded OTTI charges of \$29.3 thousand on an investment in agency interest-only MBS. We recorded no OTTI charges on agency interest-only MBS for the six months ended June 30, 2013.

The gains on trading investments, net, recognized for the six months ended June 30, 2014 were primarily the result of net mark-to-market gain adjustments of \$62.5 million. There were no sales of trading investments for the six months ended June 30, 2014. The losses on trading investments, net, recognized for the six months ended June 30, 2013 were primarily the result of net mark-to-market loss adjustments of \$85.1 million and net losses of \$6.4 million from sales of trading investments. The securities sold during the six months ended June 30, 2013 had \$0.9 million in net cumulative losses from the acquisition price.

The losses from derivative instruments recognized for the six months ended June 30, 2014 were the result of net realized losses of \$16.1 million and net unrealized mark-to-market loss adjustments of \$54.0 million. The derivative instruments closed during the six months ended June 30, 2014 had \$16.8 million in net cumulative losses from the acquisition price. Gains from derivative instruments recognized for the six months ended June 30, 2013 were the result of net realized gains of \$3.0 million and net unrealized mark-to-market gain adjustments of \$56.0 million. The derivative instruments closed during the six months ended June 30, 2013 had \$4.3 million in net cumulative losses from the acquisition price. The value of our hedge instruments is expected to fluctuate inversely relative to the change in value of the agency-backed MBS portfolio.

### **Other Expenses**

Other expenses increased by \$0.8 million (10.4%) from \$7.7 million for the six months ended June 30, 2013 to \$8.5 million for the six months ended June 30, 2014. The increase is primarily a result of increases in compensation expenses offset by a decrease in legal expenses.

### **Income Tax Provision (Benefit)**

Total income tax provision increased from a benefit of \$1.2 million for the six months ended June 30, 2013 to a provision of \$16.6 million for the six months ended June 30, 2014. The increase in income tax provision was due primarily to the realization of previously unrecognized tax benefits including related accrued interest that were fully reserved related to an uncertain tax position during the six months ended June 30, 2013. As a result, our effective tax rate for the six months ended June 30, 2013 was lower than the statutory tax rate. There was no such activity during the six months ended June 30, 2014. The net deferred tax assets, which are partially offset by a valuation allowance, include NOLs, which are available to offset the current and future taxable income. We recorded an expected tax liability for the period due to being subject to alternative minimum tax.

## **Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements including ongoing commitments to repay borrowings, fund investments, and for other general business purposes. Our primary sources of funds for liquidity consist of short-term borrowings (*e.g.*, repurchase agreements), principal and interest payments on MBS and



proceeds from sales of MBS. Other sources of liquidity include proceeds from the offering of common stock, preferred stock, debt securities or other securities registered pursuant to our effective shelf registration statement filed with the SEC. The 2011 Shelf Registration statement expired on January 20, 2014. On January 22, 2014 we filed a shelf registration statement on Form S-3 (File No. 333-193478) with the SEC (the 2014 Shelf Registration) to replace the expired shelf registration statement. The 2014 Shelf Registration was declared effective by the SEC on February 5, 2014. The 2014 Shelf Registration statement permits us to issue and publicly distribute various types of securities, including Class A common stock, preferred stock, debt securities, warrants and units, or any combination of such securities, from time to time, in one or more offerings, up to an aggregate amount of \$750.0 million.

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Pursuant to our 2014 Shelf Registration statement, on March 28, 2014, we completed a public offering of 3,062,500 shares of Class A common stock, including 312,500 shares purchased by the underwriters pursuant to an option granted by us to cover over-allotments, at a public offering price of \$27.40 per share, for net proceeds of \$81.7 million, after deducting underwriting discounts and commissions and expenses.

Liquidity, or ready access to funds, is essential to our business. Liquidity is of particular importance to our business and perceived liquidity issues may affect our counterparties' willingness to engage in transactions with us. Our liquidity could be impaired due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects us or third parties. Further, our ability to sell assets may be impaired if other market participants are seeking to sell similar assets at the same time. If we cannot obtain funding from third parties or from our subsidiaries, our results of operations could be negatively impacted.

Potential future sources of liquidity for us include existing cash balances, borrowing capacity through margin accounts and repurchase agreements and cash flows from operations, future issuances of common stock, preferred stock, debt securities or other securities registered pursuant to our shelf registration statement. Funding for agency-backed MBS through repurchase agreements continues to be available to us at rates we consider to be attractive from multiple counterparties, and we have observed increased availability for funding for private-label MBS through repurchase agreements.

## **Cash Flows**

As of June 30, 2014, our cash and cash equivalents totaled \$27.0 million, representing a net decrease of \$21.6 million from \$48.6 million as of December 31, 2013. The cash provided by operating activities of \$19.7 million during the six months ended June 30, 2014 was attributable primarily to net income. The cash used in investing activities of \$1.2 billion relates primarily to purchases of MBS, net of sales of MBS. The cash provided by financing activities of \$1.2 billion relates primarily to proceeds from repurchase agreements used to finance a portion of the MBS portfolio and from a completed public offering.

## **Sources of Funding**

We believe that our existing cash balances, net investments in MBS, cash flows from operations, borrowing capacity and other sources of liquidity will be sufficient to meet our cash requirements for at least the next 12 months. We have obtained, and believe we will be able to continue to obtain, short-term financing in amounts and at interest rates consistent with our financing objectives. We may, however, seek debt or equity financings, in public or private transactions, to provide capital for corporate purposes and/or strategic business opportunities, including possible acquisitions, joint ventures, alliances or other business arrangements which could require substantial capital outlays. Our policy is to evaluate strategic business opportunities, including acquisitions and divestitures, as they arise. There can be no assurance that we will be able to generate sufficient funds from future operations, or raise sufficient debt or equity on acceptable terms, to take advantage of investment opportunities that become available. Should our needs ever exceed these sources of liquidity, we believe that most of our investments could be sold, in most circumstances, to provide cash. However, we may be required to sell our assets in such instances at depressed prices.

As of June 30, 2014, our liabilities totaled \$2.8 billion. In addition to other payables and accrued expenses, our indebtedness consisted of repurchase agreements and long-term debt. As of June 30, 2014, we had \$40.0 million of total long-term debt. Our trust preferred debt with a principal amount of \$15.0 million outstanding as of June 30, 2014 accrues and requires payment of interest quarterly at annual rates of three-month LIBOR plus 2.25% to 3.00% and matures between 2033 and 2035. Our 6.625% Senior Notes due 2023 with a principal amount of \$25.0 million

outstanding as of June 30, 2014 accrue and require payment of interest quarterly at an annual rate of 6.625% and mature on May 1, 2023. As of June 30, 2014, our debt-to-equity leverage ratio was 4.3 to 1.

We also have short-term financing facilities that are structured as repurchase agreements with various financial institutions to primarily fund our portfolio of agency-backed MBS. As of June 30, 2014, the weighted-average interest rate under these agreements was 0.36%. Our repurchase agreements include provisions contained in the standard master repurchase agreement as published by the Securities Industry and Financial Markets Association and may be amended and supplemented in accordance with industry standards

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for repurchase facilities. Our repurchase agreements include financial covenants, with which the failure to comply would constitute an event of default under the applicable repurchase agreement. Similarly, each repurchase agreement includes events of insolvency and events of default on other indebtedness. As provided in the standard master repurchase agreement as typically amended, upon the occurrence of an event of default or termination event the applicable counterparty has the option to terminate all repurchase transactions under such counterparty's repurchase agreement and to demand immediate payment of any amount due from us to the counterparty.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (*i.e.*, a margin call), which may take the form of additional securities or cash. Margin calls on repurchase agreements collateralized by our MBS investments primarily result from events such as declines in the value of the underlying mortgage collateral caused by factors such as rising interest rates or prepayments.

To date, we have not had any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should we encounter increases in interest rates or prepayments, margin calls on our repurchase agreements could result in a material adverse change in our liquidity position.

In the event that market conditions are such that we are unable to obtain financing for our investments in MBS in amounts and at interest rates consistent with our financing objectives, to the extent deemed appropriate, we may use cash to finance our investments or we may liquidate such investments. Accordingly, depending on market conditions, we may incur significant losses on any such sales of MBS.

The following table provides information regarding our outstanding repurchase agreement borrowings as of the dates and periods indicated (dollars in thousands):

|   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
| Outstanding balance   | \$2,666,251      | \$1,547,630          |
| Weighted-average rate   | 0.36%            | 0.45%                |
| Weighted-average term to maturity                             | 14.0 days        | 13.2 days            |
| Maximum amount outstanding at any month-end during the period | \$2,666,251      | \$1,801,383          |

**Assets**

Our principal assets consist of MBS, cash and cash equivalents, receivables, deposits, long-term investments and deferred tax assets. As of June 30, 2014, liquid assets consisted primarily of cash and cash equivalents of \$27.0 million and net investments in MBS of \$461.9 million. Cash equivalents consist primarily of money market funds invested in debt obligations of the U.S. government. Our total assets increased from \$2.2 billion at December 31, 2013 to \$3.4 billion as of June 30, 2014. The increase in total assets reflects the deployment of capital raised from our public offering during the six months ended June 30, 2014 on a leveraged basis into our MBS portfolio. As of June 30, 2014, the total par and fair value of the MBS portfolio was \$3.1 billion and the weighted-average coupon of the portfolio was 3.90%.

TABLE OF CONTENTS**Dividends**

Pursuant to our variable dividend policy, our Board of Directors evaluates dividends on a quarterly basis and, in its sole discretion, approves the payment of dividends. Our dividend payments, if any, may vary significantly quarter to quarter. The Board of Directors has approved and we have declared and paid the following dividends to date in 2014:

| Quarter Ended | Dividend Amount | Declaration Date | Record Date | Pay Date |
|---------------|-----------------|------------------|-------------|----------|
| June 30       | \$ 0.875        | June 11          | June 30     | July 31  |
| March 31      | 0.875           | March 13         | March 31    | April 30 |

The Board of Directors approved and the Company declared and paid the following dividends for 2013:

| Quarter Ended | Dividend Amount | Declaration Date | Record Date  | Pay Date         |
|---------------|-----------------|------------------|--------------|------------------|
| December 31   | \$ 0.875        | December 19      | December 31  | January 31, 2014 |
| September 30  | 0.875           | September 18     | September 30 | October 31       |
| June 30       | 0.875           | June 17          | June 28      | July 31          |
| March 31      | 0.875           | March 15         | March 28     | April 30         |

**Off-Balance Sheet Arrangements**

As of June 30, 2014 and December 31, 2013, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of June 30, 2014 and December 31, 2013, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Market risk generally represents the risk of loss through a change in realizable value that can result from a change in the prices of securities, a change in the value of financial instruments as a result of changes in interest rates, a change in the volatility of interest rates or a change in the credit rating of an issuer. We monitor market and business risk, including credit, interest rate, equity, operations, liquidity, compliance, legal, reputational, and equity ownership risks through a number of control procedures designed to identify and evaluate the various risks to which our business and assets are exposed. See Item 1 Business in our Annual Report on Form 10-K for the year ended December 31, 2013 for a discussion of our risk management strategies.

We are exposed to the following market risks as a result of our investments in MBS and equity investments.

**Credit Risk**

Although we do not expect to encounter credit risk in our agency-backed MBS portfolio assuming Fannie Mae and Freddie Mac remain solvent, we are exposed to credit risk in our private-label MBS portfolio. With respect to our

private-label MBS, credit support contained in these MBS deal structures provides a level of protection from losses, as do the discounted purchase prices in the event of the return of less than 100% of par. We also evaluate the impact of credit risk on our investments through a comprehensive investment review and selection process, which is predominantly focused on quantifying and pricing credit risk. We review our private-label MBS based on quantitative and qualitative analysis of the risk-adjusted returns on such investments. Through modeling and scenario analysis, we seek to evaluate each investment's credit risk. Credit risk is also monitored through our ongoing asset surveillance.

Despite these measures to manage credit risk, unanticipated credit losses could nevertheless occur, which could adversely impact our operating results.

Our private-label MBS are generally purchased at a discount. We estimate the future expected cash flows based on our observation of current information and events and applying a number of assumptions related to prepayment rates, interest rates, default rates, and the timing and amount of credit losses on each security. These assumptions are difficult to predict as they are subject to uncertainties and contingencies related to future events that may impact our estimates and interest income.

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The following table represents certain statistics of our private-label MBS portfolio as of and for the three months ended June 30, 2014:

|   | Total<br>Private-Label<br>Securities |
|---|--------------------------------------|
| Yield (% of amortized cost)                     | 10.4 %                               |
| Average cost (% of face value)                  | 53.8 %                               |
| Weighted-average coupon                         | 3.0 %                                |
| Delinquencies greater than 60 plus days         | 14.6 %                               |
| Credit enhancement                              | 0.3 %                                |
| Severity (three months average)                 | 32.1 %                               |
| Constant prepayment rate (three months average) | 11.3 %                               |

Key credit and prepayment measures in our private-label MBS portfolio reflected improvement during the three months ended June 30, 2014. Total 60-day plus delinquencies in our private-label MBS portfolio decreased to 14.6% at June 30, 2014 from 15.0% at March 31, 2014 and trailing three month average loss severities on liquidated loans decreased to 32.1% at June 30, 2014 from 32.6% at March 31, 2014. We will continue to monitor the performance of each security in our portfolio and assess the impact on the overall performance of the portfolio.

The table that follows shows the expected change in fair value for our current private-label MBS related to our principal investing activities under several hypothetical credit loss scenarios. Our private-label MBS are classified as Level 3 assets of the fair value hierarchy as they are valued using present value techniques based on estimated cash flows of the security taking into consideration various assumptions derived by management and used by other market participants. These assumptions include, among others, interest rates, prepayment rates, discount rates, credit loss rates, and the timing of cash flows and credit losses. Credit default and loss severity rates can significantly affect the prices of private-label MBS. While it is impossible to project the exact amount of changes in value, the table below illustrates the impact a 10% increase and a 10% decrease in the credit default and loss severity rates from those used as our valuation assumptions would have on the value of our total assets and our book value as of June 30, 2014. The changes in rates are assumed to occur instantaneously. Actual changes in market conditions are likely to be different from these assumptions (dollars in thousands, except per share amounts).

|                    | June 30, 2014 |   |                   |   |                   |  |                   |  |                   |
|--------------------|---------------|---|-------------------|---|-------------------|--|-------------------|--|-------------------|
|                    | Value         | Value with<br>10%<br>Increase<br>in Default<br>Rate | Percent<br>Change | Value with<br>10%<br>Decrease<br>in Default<br>Rate | Percent<br>Change | Value with<br>10%<br>Increase<br>in Loss<br>Severity<br>Rate | Percent<br>Change | Value with<br>10%<br>Decrease in<br>Loss<br>Severity<br>Rate | Percent<br>Change |
| Assets             |               |   |                   |   |                   |  |                   |  |                   |
| MBS, Private-label | \$314,148     | \$309,730   | (1.41)%           | \$318,674   | 1.44%             | \$308,737  | (1.72)%           | \$319,561  | 1.72%             |
| MBS, Agency        | 2,814,024     | 2,814,024   |                   | 2,814,024   |                   | 2,814,024  |                   | 2,814,024  |                   |
| Other              | 303,566       | 303,566   |                   | 303,566   |                   | 303,566  |                   | 303,566  |                   |
| Total assets       | \$3,431,738   | \$3,427,320   | (0.13)%           | \$3,436,264   | 0.13%             | \$3,426,327  | (0.16)%           | \$3,437,151  | 0.16%             |
| Liabilities        | \$2,809,106   | \$2,809,106   |                   | \$2,809,106   |                   | \$2,809,106  |                   | \$2,809,106  |                   |
| Equity             | 622,632       | 618,214   | (0.71)%           | 627,158   | 0.73%             | 617,221  | (0.87)%           | 628,045  | 0.87%             |
|                    | \$3,431,738   | \$3,427,320   | (0.13)%           | \$3,436,264   | 0.13%             | \$3,426,327  | (0.16)%           | \$3,437,151  | 0.16%             |

Total liabilities and equity

|                      |         |         |         |         |       |         |         |         |       |
|----------------------|---------|---------|---------|---------|-------|---------|---------|---------|-------|
| Book value per share | \$31.51 | \$31.29 | (0.71)% | \$31.74 | 0.73% | \$31.24 | (0.87)% | \$31.79 | 0.87% |
|----------------------|---------|---------|---------|---------|-------|---------|---------|---------|-------|

## Interest Rate Risk

### Leveraged MBS

We are also subject to interest rate risk in our MBS portfolio. Some of our MBS positions are financed with repurchase agreements, which are interest rate sensitive financial instruments. We are exposed to interest rate risk that fluctuates based on changes in the level or volatility of interest rates and mortgage prepayments and in the shape and slope of the yield curve. We attempt to hedge a portion of our exposure to interest rate fluctuations through the use of Eurodollar futures, U.S. Treasury note futures, and swap futures. The counterparties to our derivative agreements at June 30, 2014 are various exchanges. We assess and monitor the counterparties' non-performance risk and credit risk on a regular basis.



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Our primary risk is related to changes in both short- and long-term interest rates, which affect us in several ways. As interest rates increase, the market value of the MBS may be expected to decline, prepayment rates may be expected to go down, and duration may be expected to extend. An increase in interest rates is beneficial to the market value of our derivative instruments. For example, for interest rate swap futures, the cash flows from receiving the floating rate portion increase and the fixed-rate paid remains the same under this scenario. If interest rates decline, the reverse is true for MBS, paying fixed and receiving floating interest rate swaps, interest rate caps, and Eurodollar and U.S. Treasury futures.

The table that follows shows the expected change in fair value for our current MBS and derivatives related to our principal investing activities under several hypothetical interest-rate scenarios. Interest rates are defined by the U.S. Treasury yield curve. The changes in rates are assumed to occur instantaneously. It is further assumed that the changes in rates occur uniformly across the yield curve and that the level of LIBOR changes by the same amount as the yield curve. Actual changes in market conditions are likely to be different from these assumptions.

Changes in value are measured as percentage changes from their respective values presented in the column labeled Value. Management's estimate of change in value for MBS is based on the same assumptions it uses to manage the impact of interest rates on the portfolio. Actual results could differ significantly from these estimates. For MBS, the estimated change in value of the MBS reflects an effective duration of 5.57 in a rising interest rate environment and 4.08 in a declining interest rate environment.

The effective durations are based on observed market value changes, as well as management's own estimate of the effect of interest rate changes on the fair value of the investments including assumptions regarding prepayments based, in part, on age of and interest rate on the mortgages underlying the MBS, prior exposure to refinancing opportunities, and an overall analysis of historical prepayment patterns under a variety of past interest rate conditions (dollars in thousands, except per share amounts).

|                              | June 30, 2014 |   |                   |  |  |                   |
|------------------------------|---------------|---|-------------------|--|--|-------------------|
|                              | Value         | Value with<br>100 Basis<br>Point Increase<br>in Interest<br>Rates | Percent<br>Change |  | Value with<br>100 Basis<br>Point<br>Decrease in<br>Interest<br>Rates | Percent<br>Change |
| Assets                       |               |   |                   |  |  |                   |
| MBS                          | \$ 3,128,172  | \$ 2,954,001  | (5.57 )%          |  | \$ 3,255,945   | 4.08 %            |
| Derivative asset             | 2,556         | 1,844   | (27.86 )%         |  | 840  | (67.14 )%         |
| Other                        | 301,010       | 301,010   |                   |  | 301,010  |                   |
| Total assets                 | \$ 3,431,738  | \$ 3,256,855  | (5.10 )%          |  | \$ 3,557,795   | 3.67 %            |
| Liabilities                  |               |   |                   |  |  |                   |
| Repurchase agreements        | \$ 2,666,251  | \$ 2,666,251  |                   |  | \$ 2,666,251   |                   |
| Derivative liability         | 80,487        | (79,367 )   | (198.61 )%        |  | 236,885  | 194.31 %          |
| Other                        | 62,368        | 62,368  |                   |  | 62,368   |                   |
| Total liabilities            | 2,809,106     | 2,649,252   | (5.69 )%          |  | 2,965,504  | 5.57 %            |
| Equity                       | 622,632       | 607,603   | (2.41 )%          |  | 592,291  | (4.87 )%          |
| Total liabilities and equity | \$ 3,431,738  | \$ 3,256,855  | (5.10 )%          |  | \$ 3,557,795   | 3.67 %            |
| Book value per share         | \$ 31.51      | \$ 30.75  | (2.41 )%          |  | \$ 29.98   | (4.87 )%          |

## Equity Price Risk

Although limited, we are exposed to equity price risk as a result of our investments in equity securities and investment partnerships. Equity price risk changes as the volatility of equity prices changes or the values of corresponding equity indices change.

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While it is impossible to exactly project what factors may affect the prices of equity sectors and how much the effect might be, the table below illustrates the impact a 10% increase and a 10% decrease in the price of the equities held by us would have on the value of our total assets and our book value as of June 30, 2014 (dollars in thousands, except per share amounts).

|                                    | June 30, 2014 |  |                   |   |                   |
|------------------------------------|---------------|--|-------------------|---|-------------------|
|                                    | Value         | Value with<br>10% Increase<br>in Price | Percent<br>Change | Value with<br>10%<br>Decrease in<br>Price | Percent<br>Change |
| Assets                             |               |  |                   |   |                   |
| Equity and cost method investments | \$ 1,820      | \$ 2,002                               | 10.00 %           | \$ 1,638                                  | (10.00)%          |
| Other                              | 3,429,918     | 3,429,918                              |                   | 3,429,918                                 |                   |
| Total assets                       | \$ 3,431,738  | \$ 3,431,920                           | 0.01 %            | \$ 3,431,556                              | (0.01)%           |
| Liabilities                        | \$ 2,809,106  | \$ 2,809,106                           |                   | \$ 2,809,106                              |                   |
| Equity                             | 622,632       | 622,814                                | 0.03 %            | 622,450                                   | (0.03)%           |
| Total liabilities and equity       | \$ 3,431,738  | \$ 3,431,920                           | 0.01 %            | \$ 3,431,556                              | (0.01)%           |
| Book value per share               | \$ 31.51      | \$ 31.52                               | 0.03 %            | \$ 31.50                                  | (0.03)%           |

Except to the extent that we sell our equity securities or other investments, or a decrease in their fair value is deemed to be other-than-temporary, an increase or decrease in the fair value of those assets will not directly affect our earnings; however, an increase or decrease in the value of equity method investments will directly affect our earnings.

## Inflation Risk

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our distributions are determined by our Board of Directors in its sole discretion pursuant to our variable dividend policy; in each case, our activities and balance sheet are measured with reference to fair value without considering inflation.

## Cautionary Statement About Forward-Looking Statements

When used in this Quarterly Report on Form 10-Q, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as believe, expect, anticipate, estimate, plan, continue, intend, should, may or similar expressions, identify forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Exchange Act and, as such, may involve known and unknown risks, uncertainties and assumptions. The forward-looking statements we make in this Quarterly Report on Form 10-Q include, but are not limited to, statements about the following:

the availability and terms of, and our ability to deploy, capital and our ability to grow our business through a strategy focused on acquiring primarily residential mortgage-backed securities (MBS) that are either issued by U.S. government agencies or guaranteed as to principal and interest by U.S. government agencies or U.S. government sponsored agencies (agency-backed MBS), and MBS issued by private organizations (private-label MBS); our ability to forecast our tax attributes, which are based upon various facts and assumptions, and our ability to protect and use our net operating losses (NOLs), and net capital losses (NCLs), to offset future taxable income, including

whether our shareholder rights plan (Rights Plan) will be effective in preventing an ownership change that would significantly limit our ability to utilize such losses;  
our business, acquisition, leverage, asset allocation, operational, investment, hedging and financing strategies and the success of these strategies;

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the effect of changes in prepayment rates, interest rates and default rates on our portfolio;  
the effect of governmental regulation and actions;  
our ability to quantify and manage risk;  
our ability to realize any reflation of our assets;  
our liquidity;  
our asset valuation policies;  
our decisions with respect to, and ability to make, future dividends;  
investing in assets other than MBS or pursuing business activities other than investing in MBS;  
our ability to maintain our exclusion from the definition of investment company under the Investment Company Act of 1940, as amended (the 1940 Act); and  
the effect of general economic conditions on our business.

Forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account information currently in our possession. These beliefs, assumptions and expectations may change as a result of many possible events or factors, not all of which are known to us or are within our control. If a change occurs, the performance of our portfolio and our business, financial condition, liquidity and results of operations may vary materially from those expressed, anticipated or contemplated in our forward-looking statements. You should carefully consider these risks, along with the following factors that could cause actual results to vary from our forward-looking statements, before making an investment in our securities:

the overall environment for interest rates, changes in interest rates, interest rate spreads, the yield curve and prepayment rates;  
current conditions and further adverse developments in the residential mortgage market and the overall economy;  
potential risk attributable to our mortgage-related portfolios, including changes in fair value;  
our use of leverage and our dependence on repurchase agreements and other short-term borrowings to finance our mortgage-related holdings;  
the availability of certain short-term liquidity sources;  
competition for investment opportunities, including competition from the U.S. Department of Treasury (U.S. Treasury) and the U.S. Federal Reserve, for investments in agency-backed MBS, as well as the reduction by the U.S. Federal Reserve of its purchases of agency-backed MBS;  
the federal conservatorship of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government;  
mortgage loan prepayment activity, modification programs and future legislative action;  
changes in our acquisition, hedging and leverage strategies, changes in our asset allocation and changes in our operational policies, all of which may be changed by us without shareholder approval;  
failure of sovereign or municipal entities to meet their debt obligations or a downgrade in the credit rating of such debt obligations;  
fluctuations of the value of our hedge instruments;  
fluctuating quarterly operating results;

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changes in laws and regulations and industry practices that may adversely affect our business; volatility of the securities markets and activity in the secondary securities markets; our ability to successfully expand our business into areas other than investing in MBS; and the other important factors identified in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2013 under the caption Item 1A Risk Factors . These and other risks, uncertainties and factors, including those described elsewhere in this Quarterly Report on Form 10-Q, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements speak only as of the date on which they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## **Item 4. Controls and Procedures**

### **Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

As of the end of the period covered by this Quarterly Report on Form 10-Q, our management, with the participation of our Chief Executive Officer, J. Rock Tonkel, Jr., and our Chief Financial Officer, Kurt R. Harrington, carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure.

### **Changes in Internal Control Over Financial Reporting**

There has been no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2014 that has materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II**  
**OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are from time to time involved in civil lawsuits, legal proceedings and arbitration matters relating to our business that we consider to be in the ordinary course. There can be no assurance that these matters individually or in aggregate will not have a material adverse effect on our financial condition or results of operations in a future period. We are also subject to the risk of litigation, including litigation that may be without merit. As we intend to actively defend such litigation, significant legal expenses could be incurred. An adverse resolution of any future litigation against us could materially affect our financial condition, results of operations and liquidity. Furthermore, we operate in highly-regulated markets that currently are under intense regulatory scrutiny, and we have received, and we expect in the future that we may receive, inquiries and requests for documents and information from various federal, state and foreign regulators. In addition, one or more of our subsidiaries have received requests to repurchase loans from various parties in connection with the former securitization business conducted by a subsidiary. We believe that the continued scrutiny of MBS, structured financed and derivative market participants increases the risk of additional inquiries and requests from regulatory or enforcement agencies and other parties. We cannot provide any assurance that these inquiries and requests will not result in further investigation of or the initiation of a proceeding against us or that, if any such investigation or proceeding were to arise, it would not materially adversely affect our Company.

**Item 1A. Risk Factors**

None.

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

**Purchases of Equity Securities by the Issuer**

During the three months ended June 30, 2014, we did not repurchase any shares of our Class A common stock.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.





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**Item 6. Exhibits**

| Exhibit Number | Exhibit Title  |
|----------------|--|
| 3.1            | Amended and Restated Articles of Incorporation of the Company, as amended (incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q filed on November 9, 2009).   |
| 3.2            | Amended and Restated Bylaws of the Company, as amended (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on July 28, 2011).  |
| 4.1            | Indenture dated as of May 1, 2013 between the Company and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.1 of the Company's Current Report on Form 8-K filed on May 1, 2013).                    |
| 4.2            | First Supplemental Indenture dated as of May 1, 2013 between the Company and Wells Fargo Bank, National Association, as trustee (incorporated by reference to Exhibit 4.2 of the Company's Current Report on Form 8-K filed on May 1, 2013). |
| 4.3            | Form of 6.625% Senior Notes due 2023 (incorporated by reference to Exhibit 4.3 to Current Report on Form 8-K filed by the Registrant on May 1, 2013).  |
| 4.4            | Form of Certificate for Class A Common Stock (incorporated by reference to Exhibit 4.01 of the Annual Report on Form 10-K filed with the SEC on February 24, 2010).  |
| 4.5            | Shareholder Rights Agreement, dated June 5, 2009 (incorporated by reference to Exhibit 4.1 of the Current Report on Form 8-K filed with the SEC on June 5, 2009).  |
| 10.1           | Arlington Asset Investment Corp. 2014 Long-Term Incentive Plan (incorporated by reference to the Company's Registration Statement on Form S-8 filed on July 15, 2014).   |
| 10.2           | Form of Restricted Stock Unit Agreement under Arlington Asset Investment Corp. 2014 Long-Term Incentive Plan (incorporated by reference to the Company's Registration Statement on Form S-8 filed on July 15, 2014).                         |
| 10.3           | Form of Restricted Stock Award Agreement under Arlington Asset Investment Corp. 2014 Long-Term Incentive Plan (incorporated by reference to the Company's Registration Statement on Form S-8 filed on July 15, 2014).                        |
| 10.4           | Form of Performance Share Unit Award Agreement under Arlington Asset Investment Corp. 2014 Long-Term Incentive Plan (incorporated by reference to the Company's Registration Statement on Form S-8 filed on July 15, 2014).                  |
| 12.1           | Computation of Ratio of Earnings to Fixed Charges.*  |
| 31.1           | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*   |
| 31.2           | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*   |
| 32.1           | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**   |
| 32.2           | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**   |
| 101.INS        | INSTANCE DOCUMENT.***  |
| 101.SCH        | SCHEMA DOCUMENT.***  |
| 101.CAL        | CALCULATION LINKBASE DOCUMENT.***  |

101.LAB LABELS LINKBASE DOCUMENT.\*\*\*  
101.PRE PRESENTATION LINKBASE DOCUMENT.\*\*\*  
101.DEF DEFINITION LINKBASE DOCUMENT.\*\*\*

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Filed herewith.  
Furnished herewith.

Submitted electronically herewith. Attached as Exhibit 101 are the following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets at June 30, 2014 and December 31, 2013; (ii) Consolidated \*\*\* Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2014 and 2013; (iii) Consolidated Statements of Changes in Equity for the Six Months Ended June 30, 2014 and the Year Ended December 31, 2013; and (iv) Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2014 and 2013.

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## SIGNATURES

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

**ARLINGTON ASSET INVESTMENT CORP.**

/s/ KURT R. HARRINGTON

By: **Kurt R. Harrington**  
*Executive Vice President, Chief Financial Officer, and Chief Accounting Officer*  
*(Principal Financial Officer)*

Date: August 1, 2014

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