

CAPSTEAD MORTGAGE CORP

Form 10-Q

November 05, 2009

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

**For the quarterly period ended: September 30, 2009**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 001-08896**

**CAPSTEAD MORTGAGE CORPORATION**

(Exact name of Registrant as specified in its Charter)

**Maryland**

(State or other jurisdiction of incorporation or organization)

**75-2027937**

(I.R.S. Employer Identification No.)

**8401 North Central Expressway, Suite 800, Dallas,  
TX**

(Address of principal executive offices)

**75225**

(Zip Code)

**(214) 874-2323**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

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

Common Stock (\$0.01 par value)

69,207,413 as of November 4, 2009



**CAPSTEAD MORTGAGE CORPORATION**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**  
**INDEX**

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>ITEM</u></b>	
<b><u>1.</u></b> <b><u>Financial Statements (unaudited)</u></b>	
<u>Consolidated Balance Sheets – September 30, 2009 and December 31, 2008</u>	3
<u>Consolidated Statements of Income – Quarter and Nine Months Ended September 30, 2009 and 2008</u>	4
<u>Consolidated Statements of Cash Flows – Nine Months Ended September 30, 2009 and 2008</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<b><u>ITEM</u></b> <b><u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u></b>	
<b><u>2.</u></b>	20
<b><u>ITEM</u></b> <b><u>Qualitative and Quantitative Disclosure of Market Risk</u></b>	
<b><u>3.</u></b>	40
<b><u>ITEM</u></b> <b><u>Controls and Procedures</u></b>	
<b><u>4.</u></b>	40
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>ITEM</u></b> <b><u>Exhibits and Reports on Form 8-K</u></b>	
<b><u>6.</u></b>	41
<b><u>SIGNATURES</u></b>	42
Computation of Ratio of Income from Continuing Operations	
Certification Pursuant to Section 302(a)	
Certification Pursuant to Section 302(a)	
Certification Pursuant to Section 906	
<u>EX-12</u>	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32</u>	

**Table of Contents**

**ITEM 1. FINANCIAL STATEMENTS**  
**PART I. FINANCIAL INFORMATION**  
**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
*(in thousands, except per share amounts)*

	<i>September 30, 2009 (unaudited)</i>	<i>December 31, 2008</i>
<b>Assets:</b>		
Mortgage securities and similar investments (\$7.40 billion pledged under repurchase arrangements)	\$ 7,920,478	\$ 7,499,249
Cash collateral receivable from interest rate swap counterparties	35,966	53,676
Interest rate swap agreements at fair value	43	
Cash and cash equivalents	168,496	96,839
Receivables and other assets	80,797	76,481
Investments in unconsolidated affiliates	3,117	3,117
	\$ 8,208,897	\$ 7,729,362
<b>Liabilities:</b>		
Repurchase arrangements and similar borrowings	\$ 6,992,755	\$ 6,751,500
Unsecured borrowings	103,095	103,095
Interest rate swap agreements at fair value	20,472	46,679
Common stock dividend payable	38,695	22,728
Accounts payable and accrued expenses	27,149	44,910
	7,182,166	6,968,912
<b>Stockholders equity:</b>		
Preferred stock \$0.10 par value; 100,000 shares authorized: \$1.60 Cumulative Preferred Stock, Series A, 188 and 197 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively (\$3,085 aggregate liquidation preference)	2,630	2,755
\$1.26 Cumulative Convertible Preferred Stock, Series B, 15,819 shares issued and outstanding at September 30, 2009 and December 31, 2008 (\$180,025 aggregate liquidation preference)	176,705	176,705
Common stock \$0.01 par value; 250,000 shares authorized: 69,098 and 63,135 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively	691	631
Paid-in capital	1,055,114	975,893
Accumulated deficit	(356,154)	(358,155)
Accumulated other comprehensive income (loss)	147,745	(37,379)
	1,026,731	760,450

\$ 8,208,897 \$ 7,729,362

*See accompanying notes to consolidated financial statements.*

-3-

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Table of Contents

**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**  
*(in thousands, except per share amounts)*  
*(unaudited)*

	<i>Quarter Ended</i>		<i>Nine Months Ended</i>	
	<i>September 30</i>		<i>September 30</i>	
	<i>2009</i>	<i>2008</i>	<i>2009</i>	<i>2008</i>
<b>Interest income:</b>				
Mortgage securities and similar investments	\$ 74,695	\$ 99,205	\$ 243,641	\$ 302,888
Other	69	346	419	1,932
	74,764	99,551	244,060	304,820
<b>Interest expense:</b>				
Repurchase arrangements and similar borrowings	(26,802)	(60,032)	(98,385)	(184,357)
Unsecured borrowings	(2,186)	(2,186)	(6,560)	(6,560)
	(28,988)	(62,218)	(104,945)	(190,917)
	45,776	37,333	139,115	113,903
<b>Other revenue (expense):</b>				
Miscellaneous other revenue (expense)	16	(45)	(893)	(1,469)
Incentive compensation expense	(1,058)	(300)	(3,435)	(4,820)
General and administrative expense	(2,713)	(2,306)	(8,313)	(6,187)
	(3,755)	(2,651)	(12,641)	(12,476)
<b>Income before equity in earnings of unconsolidated affiliates</b>	42,021	34,682	126,474	101,427
<b>Equity in earnings of unconsolidated affiliates</b>	64	64	194	194
<b>Net income</b>	\$ 42,085	\$ 34,746	\$ 126,668	\$ 101,621
<b>Net income available to common stockholders:</b>				
Net income	\$ 42,085	\$ 34,746	\$ 126,668	\$ 101,621
Less cash dividends paid on preferred shares	(5,058)	(5,062)	(15,180)	(15,189)
	\$ 37,027	\$ 29,684	\$ 111,488	\$ 86,432
<b>Net income per common share:</b>				

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Basic	\$ 0.56	\$ 0.52	\$ 1.74	\$ 1.65
Diluted	0.56	0.52	1.71	1.63

**Cash dividends declared per share:**

Common	\$ 0.560	\$ 0.550	\$ 1.700	\$ 1.660
Series A Preferred	0.400	0.400	1.200	1.200
Series B Preferred	0.315	0.315	0.945	0.945

*See accompanying notes to consolidated financial statements.*

-4-

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**Table of Contents**

**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
*(in thousands, unaudited)*

	<i>Nine Months Ended September</i>	
	<b>30</b>	
	<b>2009</b>	<b>2008</b>
<b>Operating activities:</b>		
Net income	\$ 126,668	\$ 101,621
Noncash items:		
Amortization of investment premiums	20,443	23,208
Depreciation and other amortization	205	184
Equity-based compensation costs	850	948
Amounts related to interest rate swap agreements	1,613	528
Impairment charge related to commercial loans	750	
Loss from sales of mortgage securities and similar investments		1,408
Net change in receivables, other assets, accounts payable and accrued expenses	(19,025)	17,500
Net cash provided by operating activities	131,504	145,397
<b>Investing activities:</b>		
Purchases of mortgage securities and similar investments	(1,353,875)	(2,851,297)
Proceeds from sales of mortgage securities and similar investments		766,800
Principal collections on mortgage securities and similar investments	1,065,446	1,202,737
Net cash used in investing activities	(288,429)	(881,760)
<b>Financing activities:</b>		
Proceeds from repurchase arrangements and similar borrowings	53,397,517	49,296,731
Principal payments on repurchase arrangements and similar borrowings	(53,156,255)	(48,554,240)
Payment on early termination of interest rate swap agreement		(2,275)
Decrease (increase) in cash collateral receivable from interest rate swap counterparties	17,710	(22,756)
Capital stock transactions	79,979	233,739
Dividends paid	(110,369)	(84,014)
Net cash provided by financing activities	228,582	867,185
<b>Net change in cash and cash equivalents</b>	<b>71,657</b>	<b>130,822</b>
Cash and cash equivalents at beginning of period	96,839	6,653
<b>Cash and cash equivalents at end of period</b>	<b>\$ 168,496</b>	<b>\$ 137,475</b>

*See accompanying notes to consolidated financial statements.*

**Table of Contents**

**CAPSTEAD MORTGAGE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009**

*(unaudited)*

**NOTE 1 BUSINESS**

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a REIT) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as Capstead or the Company. Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored entities, either Fannie Mae or Freddie Mac (together the GSEs), or by an agency of the federal government, Ginnie Mae. Agency-guaranteed mortgage securities (Agency Securities), carry an implied AAA rating with limited, if any, credit risk.

**NOTE 2 BASIS OF PRESENTATION**

***Interim Financial Reporting and Reclassifications***

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and nine months ended September 30, 2009 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2009. For further information refer to the audited consolidated financial statements and footnotes thereto incorporated by reference into the Company's annual report on Form 10-K for the year ended December 31, 2008. Certain prior year amounts have been reclassified to conform to the current year presentation.

***Recent Accounting Developments***

In June 2008, the Financial Accounting Standards Board (FASB) issued Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (now referred to as ASC 260-10-45 under the FASB Accounting Standards Codification, or ASC). This pronouncement affects entities that accrue cash dividends on share-based payment awards during the awards' service period when the dividends do not need to be returned if any holder forfeits an award. The FASB concluded that unvested share-based payment awards that contain rights to non-forfeitable dividends are participating securities (i.e. the holders participate in dividends with common stockholders) and must be included in computing basic and diluted earnings per share, if dilutive. ASC 260-10-45 became effective for financial statements beginning January 1, 2009 and requires an entity to retroactively adjust all prior period earnings per share computations to reflect its provisions. Adopting ASC 260-10-45 did not have a material impact on the Company's consolidated financial statements.

On January 1, 2009, Capstead adopted FASB Staff Position FAS140-3 *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (ASC 860-10-40). Under ASC 860-10-40, certain seller-financed acquisitions of mortgage investments entered into after December 31, 2008 will not qualify as acquisitions if the related borrowings under repurchase arrangements are considered sufficiently linked to the acquisition transaction. Any such seller-financed acquisitions that are deemed to be sufficiently linked will generally be reported net of related financings at fair value with related changes

**Table of Contents**

in fair value reported in earnings until such time as the assets are no longer financed with the sellers. No such linked acquisitions have occurred during the quarter and nine months ended September 30, 2009; therefore, implementing ASC 860-10-40 has not had any impact on the Company's consolidated financial statements.

In April 2009, the FASB issued three concurrent Staff Positions: (i) Staff Position No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, (ii) Staff Position No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for an Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (collectively, these two pronouncements are referred to as ASC 820-10-35) and (iii) Staff Position No. FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments* (ASC 825-10-50). ASC 320-10-35 provides additional guidance for accounting for other-than-temporary impairments on debt securities. In addition to existing guidance, under ASC 320-10-35 an other-than-temporary impairment is deemed to exist if an entity does not expect to recover the entire amortized cost basis of a debt security. ASC 320-10-35 provides for the bifurcation of other-than-temporary impairments into (i) amounts related to credit losses, which are recognized through earnings, and (ii) amounts related to all other factors, which are recognized as a component of Other comprehensive income (loss). Further, ASC 320-10-35 requires certain additional disclosures for debt securities. Finally, ASC 820-10-35 provides additional guidance in determining if the market for an asset or liability is inactive and, accordingly, if quoted market prices may not be indicative of fair value. ASC 825-10-50 extends existing annual financial instrument fair value disclosure requirements to interim periods.

All three of these pronouncements were effective for periods ending after June 15, 2009 and were required to be implemented concurrently. Accordingly, Capstead adopted these pronouncements on April 1, 2009. The adoption did not have any impact on the Company's consolidated financial statements.

In May 2009, the FASB issued statement No. 165, *Subsequent Events* (Subsequent Events Topic ASC 855 or ASC 855). ASC 855 modifies the definition of what qualifies as a subsequent event—those events or transactions that occur following the balance sheet date, but before the financial statements are issued, or are available to be issued—and requires companies to disclose the date through which it has evaluated subsequent events and the basis for determining that date. ASC 855 is effective for periods ending after June 15, 2009. Accordingly, Capstead adopted the standard during the quarter ended June 30, 2009. The adoption of ASC 855 did not have any impact on the Company's consolidated financial statements. In preparing the accompanying consolidated financial statements, the Company has reviewed events that have occurred after September 30, 2009, up until the time of issuance of the financial statements on November 4, 2009.

Two of the Company's investments consist of loans secured by interests in commercial real estate. Although these loans are considered variable interests in the entities that own the underlying real estate, Capstead was not considered the primary beneficiary when these investments were made because of the substantial amounts of borrower equity at risk at origination. Although both borrowers are currently in default (See NOTE 4), no events have occurred through September 30, 2009 that would require reconsideration of whether the borrower was still the primary beneficiary under current GAAP. Therefore, these entities remain unconsolidated. In June 2009, the FASB issued statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (ASC 810-10-25). Among other items, ASC 810-10-25 responds to concerns about the application of certain key provisions of the previous pronouncement, including those regarding the transparency of the involvement with variable interest entities. ASC 810-10-25 is effective for calendar year companies beginning on January 1, 2010. Although the adoption of this statement is expected to result in the consolidation of one of these investments (the townhome development loans), this is not expected to have a material impact on the Company's consolidated financial statements.

**Table of Contents****NOTE 3 EARNINGS PER COMMON SHARE**

Basic earnings per common share is computed by dividing net income, after deducting preferred share dividends and adjusting for the impact of nonvested stock awards deemed to be participating securities, by the weighted average number of common shares outstanding, calculated excluding nonvested stock awards. Diluted earnings per common share is computed by dividing net income, after deducting dividends on convertible preferred shares when such shares are antidilutive and similar adjustments for participating securities, by the weighted average number of common shares and common share equivalents outstanding, giving effect to equity awards and convertible preferred shares, when such awards and shares are dilutive. For calculation purposes the Series A and B preferred shares are considered dilutive whenever basic earnings per common share exceeds each Series dividend divided by the conversion rate applicable for that period. Nonvested stock awards that are deemed participating securities are included in the calculation of diluted earnings per share, if dilutive, under either the two class method or the treasury stock method, depending upon which method produces the more dilutive result. Components of the computation of basic and diluted earnings per common share were as follows (dollars in thousands, except per share amounts):

	<i>Quarter Ended</i>		<i>Nine Months Ended</i>	
	<i>September 30</i>		<i>September 30</i>	
	<i>2009</i>	<i>2008</i>	<i>2009</i>	<i>2008</i>
Numerator for basic earnings per common share:				
Net income	\$ 42,085	\$ 34,746	\$ 126,668	\$ 101,621
Series A and B preferred share dividends	(5,058)	(5,062)	(15,180)	(15,189)
Basic earnings impact of nonvested stock awards	(182)	(172)	(538)	(556)
	\$ 36,845	\$ 29,512	\$ 110,950	\$ 85,876
Weighted average common shares outstanding:				
Total average shares outstanding	65,745	56,656	64,140	52,352
Average nonvested stock awards outstanding	(353)	(338)	(377)	(361)
	65,392	56,318	63,763	51,991
Basic earnings per common share	\$ 0.56	\$ 0.52	\$ 1.74	\$ 1.65
Numerator for diluted earnings per common share:				
Net income	\$ 42,085	\$ 34,746	\$ 126,668	\$ 101,621
Dividends on antidilutive convertible preferred shares		(4,983)		
Diluted earnings impact of nonvested stock awards	(182)	(172)	(538)	(556)
	\$ 41,903	\$ 29,591	\$ 126,130	\$ 101,065
Denominator for diluted earnings per common share:				
Weighted average common shares outstanding	65,392	56,318	63,763	51,991
Net effect of dilutive option awards	116	108	107	177
Net effect of dilutive convertible preferred shares	9,928	311	9,928	9,830

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75,436      56,737      73,798      61,998

Diluted earnings per common share      \$ 0.56      \$ 0.52      \$ 1.71      \$ 1.63

Potentially dilutive securities:

Antidilutive convertible preferred shares      15,819

Antidilutive equity awards excluded under the treasury  
stock method:

Shares issuable under option awards      10      40      40      10

Nonvested stock awards      148

-8-

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**Table of Contents****NOTE 4 MORTGAGE SECURITIES AND SIMILAR INVESTMENTS**

*Mortgage securities and similar investments* and related weighted average coupon rates and yields classified by collateral type and interest rate characteristics were as follows (dollars in thousands):

	<i>Principal Balance</i>	<i>Investment Premiums (Discounts)</i>	<i>Basis</i>	<i>Carrying Amount<sup>(a)</sup></i>	<i>Net WAC<sup>(b)</sup></i>	<i>Average Yield<sup>(b)</sup></i>
<b>September 30, 2009</b>						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	\$ 7,440	\$ 22	\$ 7,462	\$ 7,481	6.72%	6.47%
ARMs	7,230,701	98,730	7,329,431	7,491,764	4.42	3.96
Ginnie Mae ARMs	344,877	1,864	346,741	351,823	4.22	4.06
	7,583,018	100,616	7,683,634	7,851,068	4.41	3.96
Residential mortgage loans:						
Fixed-rate	3,737	6	3,743	3,743	7.00	6.67
ARMs	8,482	76	8,558	8,558	4.41	4.57
	12,219	82	12,301	12,301	5.20	5.27
Commercial loans and securities	54,400	67	54,467	53,436	1.85	1.40
Collateral for structured financings	3,613	60	3,673	3,673	8.05	5.84
	\$ 7,653,250	\$ 100,825	\$ 7,754,075	\$ 7,920,478	4.40	3.95
<b>December 31, 2008</b>						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	\$ 9,991	\$ 31	\$ 10,022	\$ 10,041	6.64%	6.56%
ARMs	6,928,385	90,942	7,019,327	7,029,002	5.29	4.90
Ginnie Mae ARMs	394,909	2,056	396,965	397,443	4.94	4.81
	7,333,285	93,029	7,426,314	7,436,486	5.27	4.90
Residential mortgage loans:						
Fixed-rate	5,880	(8)	5,872	5,872	7.16	7.09
ARMs	9,053	79	9,132	9,132	5.58	5.90
	14,933	71	15,004	15,004	6.20	6.36
Commercial loans	43,444		43,444	43,163	7.03	8.48

Collateral for structured financings	4,523	73	4,596	4,596	8.09	7.79
	\$ 7,396,185	\$ 93,173	\$ 7,489,358	\$ 7,499,249	5.29	4.92

(a) *Includes unrealized gains and losses for securities classified as available-for-sale, if applicable (see NOTE 9) and an allowance for possible loan losses on commercial loans totaling \$1.0 million and \$281,000 at September 30, 2009 and December 31, 2008, respectively.*

(b) *Net WAC, or weighted average coupon, is presented net of servicing and other fees as of the indicated balance sheet date. Average yield is presented for the quarter then ended, calculated including the amortization of investment premiums (discounts) and excluding unrealized gains and losses.*

Agency Securities carry an implied AAA rating and therefore limited credit risk. Residential mortgage loans held by the Company were originated prior to 1995 when Capstead operated a mortgage conduit and the related credit risk is borne by the Company. Commercial loans and securities at September 30, 2009 consist of either subordinate loans that carry credit risk associated with specific commercial real estate collateral or AAA-rated senior notes (see below). Collateral for structured financings consists of private residential mortgage pass-through securities obtained through

the above-mentioned mortgage conduit that are pledged to secure securitizations. The related credit risk is borne by bondholders of the securitizations. The maturity of mortgage securities is directly affected by prepayments of principal on



**Table of Contents**

the underlying mortgage loans. Consequently, the actual maturity of the Company's mortgage securities will be significantly shorter than the portfolio's 292 month weighted average contractual maturity.

Fixed-rate investments are generally residential mortgage loans or Agency Securities backed by mortgage loans with fixed rates of interest. Adjustable-rate investments generally are ARM Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate ( CMT ) or the one-year London interbank offered rate ( LIBOR ), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indexes such as one-month LIBOR or the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the loans.

The Company classifies its ARM securities based on each security's average number of months until coupon reset ( months-to-roll ). Current-reset ARM securities have a months-to-roll of 18 months or less while longer-to-reset ARM securities have a months-to-roll of greater than 18 months. The average months-to-roll for the \$5.69 billion (basis) in current-reset ARM securities held by the Company as of September 30, 2009 was 5.2 months compared to 29.1 months for the Company's \$1.99 billion (basis) in longer-to-reset ARM securities.

Investments in commercial loans and securities as of September 30, 2009 consisted of \$6.0 million in subordinated loans to a Dallas, Texas-based townhome developer expected to be repaid primarily through unit sales, \$38.4 million in subordinated loans collateralized by the Four Seasons hotel in Nevis, West Indies, and \$10.0 million face amount of AAA-rated senior notes issued by one of the Company's lending counterparties.

Regarding the townhome development loans, in January 2009 the Company began making advances for operating expenses on behalf of the borrower who is in financial difficulty. These advances totaled \$290,000 and \$880,000 for the quarter and nine months ended September 30, 2009. The Company curtailed recognizing interest on these loans effective January 1, 2009 and in June the Company recognized in *Miscellaneous other revenue (expense)* a \$750,000 impairment charge primarily as a result of slow sales and reduced pricing of units collateralizing the loans. With this charge, the Company's allowance for possible loan losses was increased to \$1.0 million. No additional impairment charges were recognized during the quarter ended September 30, 2009 relative to this investment.

The financing for the Nevis property matured in October 2008 and one week later it was significantly damaged by Hurricane Omar, forcing closure of the hotel. The property has wind and business interruption insurance coverage, which together with related reserves, should be sufficient to fund most rebuilding and reopening costs necessary to reopen the hotel. In September 2009 the Company settled a legal dispute with a junior lien holder, subsequently dropped its lawsuit against the lien holder and the loan servicer and, pursuant to the settlement, is currently acting as controlling holder representing the lending group. The Company is currently investigating the lending group's options for reopening the hotel and achieving an optimal recovery under the circumstances. Included in *Receivables and other assets* is \$808,000 in unpaid interest accrued on this investment during 2008; no interest has been recognized in 2009. Since default, no impairment charges have been recognized relative to this investment.

The senior notes were issued in July 2009 pursuant to a larger private placement by two large commercial banks of senior and junior notes of a lending counterparty. The notes, which bear interest at 10.0% per annum, payable monthly, mature on December 15, 2010 and are callable by the borrower at par.

**Table of Contents****NOTE 5 INVESTMENTS IN UNCONSOLIDATED AFFILIATES**

To facilitate the issuance of *Unsecured borrowings*, Capstead formed and capitalized three Delaware statutory trusts through the issuance to the Company of the trusts' common securities totaling \$3.1 million (see NOTE 7). The Company's equity in the earnings of the trusts consists solely of the common trust securities' pro rata share in interest accruing on *Unsecured borrowings* issued to the trusts.

**NOTE 6 REPURCHASE ARRANGEMENTS AND SIMILAR BORROWINGS, INCLUDING RELATED HEDGING ACTIVITY**

Capstead generally pledges its *Mortgage securities and similar investments* as collateral under uncommitted repurchase arrangements with commercial banks and other financial institutions, the terms and conditions of which are negotiated on a transaction-by-transaction basis when each borrowing is initiated or renewed. Related borrowing rates are based on prevailing rates corresponding to the terms of the borrowings. Amounts available to be borrowed are dependent upon the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates, credit quality and market liquidity conditions. In response to declines in fair value of pledged securities, lenders may require the Company to post additional collateral or pay down borrowings to re-establish agreed upon collateral requirements, referred to as margin calls. The maturity of outstanding structured financings is directly affected by prepayments on the related mortgage pass-through securities pledged as collateral and these financings are subject to redemption by the residual bondholders. *Repurchase arrangements and similar borrowings*, classified by type of collateral and maturities, and related weighted average interest rates were as follows (dollars in thousands):

<i>Collateral Type</i>	<i>September 30, 2009</i>		<i>December 31, 2008</i>	
	<i>Borrowings Outstanding</i>	<i>Average Rate *</i>	<i>Borrowings Outstanding</i>	<i>Average Rate *</i>
Borrowings with maturities of 30 days or less:				
Agency Securities	\$ 5,285,140	0.36%	\$ 5,179,137	2.74%
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)			835,628	2.87
Agency Securities (91 to 360 days)	1,703,942	0.39	732,139	5.13
	1,703,942	0.39	1,567,767	3.93
Similar borrowings:				
Collateral for structured financings	3,673	8.05	4,596	8.09
	\$ 6,992,755	0.37	\$ 6,751,500	3.02

\* *Average rate is presented as of the indicated balance sheet date and does not include the effects of interest rate swap agreements held*

*as cash flow hedges on a designated portion of 30- to 90-day borrowings (see below). After giving effect to these cash flow hedges, the average rate was 1.34% and 3.55% as of September 30, 2009 and December 31, 2008, respectively.*

Prior to the fourth quarter of 2007, Capstead routinely made use of longer-dated repurchase arrangements to mitigate exposure to higher short-term interest rates, particularly related to investments in longer-to-reset ARM Agency Securities. The remaining \$557 million of these longer-term committed borrowings with an average interest rate of 5.17% matured in August 2009. Late in 2007 the Company began using two-year term, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements for this purpose in lieu of longer-dated repurchase arrangements. As of September 30, 2009, the Company's swap positions consisted of 23 swap agreements with four large commercial banks with notional amounts totaling \$2.80 billion at average fixed rates of 2.76% and average remaining terms of nine months, including agreements with notional amounts totaling \$900 million with average fixed rates of 4.03% that terminate in November and December 2009; \$800 million with average fixed rates of 2.84% that terminate during the quarter ended March 31, 2010; \$200 million with average fixed rates of 3.17% that terminate during the quarter ended June 30, 2010; and \$900 million with average fixed rates of 1.33% that terminate between January and September 2011.

-11-

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**Table of Contents**

All swap agreements have been designated as cash flow hedges of the variability of the underlying benchmark interest rate of certain current and forecasted 30- to 90-day repurchase arrangements. This hedge relationship in effect establishes a relatively stable fixed rate on the designated borrowings with the variable-rate payments to be received on the swap agreements providing an offset to interest accruing on the designated borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company's effective borrowing rate, subject to certain adjustments including the effects of measured hedge ineffectiveness and the spread between variable rates on the swap agreements and related actual borrowing rates. Disclosures related to these Derivatives were as follows as of and for the indicated periods (in thousands):

<i>Balance Sheet Location</i>	<i>September 30, 2009</i>	<i>December 31, 2008</i>
-----------------------------------	-----------------------------------	----------------------------------

**Balance sheet-related**

Derivatives designated as cash flow hedging instruments:

Interest rate swap agreements at fair value assets	(a)	\$ 43	\$	
Interest rate swap agreements at fair value (liabilities) <sup>(c)</sup>	(a)	(20,472)		(46,679)
Related net interest payable	(b)	(18,065)		(12,909)
		\$ (38,494)	\$	(59,588)

**Location of  
Gain or  
(Loss)  
Recognized  
in  
Net Income**

**Quarter Ended**

**Nine Months Ended**

	<b>September 30 2009</b>	<b>2008</b>	<b>September 30 2009</b>	<b>2008</b>
Components of effect on interest expense:				
Amount of gain (loss) reclassified from AOCI:				
Effective portion of active positions	\$ (15,558)	\$ (3,751)	\$ (41,201)	\$ (7,013)
Effective portion of terminated positions <sup>(d)</sup>	(342)	(342)	(901)	(591)
	(15,900)	(4,093)	(42,102)	(7,604)
Amount of gain (loss) recognized (ineffective portion)	(631)	(106)	(983)	804
(Increase) decrease in interest expense	(16,531)	(4,199)	(43,085)	(6,800)
Holding gains on interest rate swap agreements realized prior to designation as cash flow hedges				81
Decrease in <i>Net income</i> as a result of the use of interest rate swap agreements	\$ (16,531)	\$ (4,199)	\$ (43,085)	\$ (6,719)

**Other comprehensive income-related:**

Amount of gain (loss) recognized in  
other comprehensive income (loss)  
(effective portion)

\$ (6,191)      \$ (5,252)      \$ (14,240)      \$ (10,632)

(a) *Included under  
this caption on  
the face of the  
balance sheet or  
statement of  
income.*

(b) *Included in  
Accounts  
payable and  
accrued  
expenses on the  
face of the  
balance sheet.*

(c) *The estimated  
amount of  
unrealized  
losses that will  
be recognized in  
the statement of  
income over the  
next twelve  
months in the  
form of fixed  
and variable  
rate swap  
payments in  
excess of  
current market  
rates totaled  
\$22.7 million as  
of  
September 30,  
2009.*

(d) *In March 2008  
a swap  
agreement with  
a \$100 million  
notional amount  
was terminated  
for a realized  
loss of*

*\$2.3 million  
which is being  
amortized to  
earnings over  
the original  
two-year term of  
the Derivative  
(through  
January 2010).*

*(e) Included in  
Miscellaneous  
other revenue  
(expense) on the  
face of the  
statement of  
income.*

-12-

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**Table of Contents**

The Company's interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with Topic 820 Fair Value Measurements and Disclosures (ASC 820-10-35). In determining fair value estimates for these agreements, the Company utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts based on expected future interest rates derived from observable market interest rate curves. The Company also incorporates both its own nonperformance risk and its counterparties' nonperformance risk as applicable in determining the fair value of its interest rate swap agreements. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation of these agreements.

**NOTE 7 UNSECURED BORROWINGS**

*Unsecured borrowings* consist of 30-year junior subordinated notes issued in 2006 and 2005 to three special-purpose, statutory trusts. These unconsolidated affiliates of the Company were formed to issue \$3.1 million of the trusts common securities to Capstead and to privately place \$100 million of preferred securities with unrelated third party investors. Included in *Receivables and other assets* are \$2.6 million in remaining issue costs associated with these transactions. Note balances and related weighted average interest rates as of September 30, 2009 and December 31, 2008 (calculated including issue cost amortization) were as follows (dollars in thousands):

	<i>Borrowings Outstanding</i>	<i>Average Rate</i>
Junior subordinated notes:		
Capstead Mortgage Trust I	\$ 36,083	8.31%
Capstead Mortgage Trust II	41,238	8.46
Capstead Mortgage Trust III	25,774	8.78
	\$ 103,095	8.49

The junior subordinated notes pay interest to the trusts quarterly calculated at fixed rates of 8.19% to 8.685% for ten years from issuance and subsequently at prevailing three-month LIBOR rates plus 3.30% to 3.50% for 20 years, reset quarterly. The trusts remit dividends pro rata to the common and preferred trust securities based on the same terms as the subordinated notes provided that payments on the trusts' common securities are subordinate to payments on the related preferred securities. The Capstead Mortgage Trust I notes and trust securities mature in October 2035 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after October 30, 2010. The Capstead Mortgage Trust II notes and trust securities mature in December 2035 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after December 15, 2015. The Capstead Mortgage Trust III notes and trust securities mature in September 2036 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after September 15, 2016. The weighted average effective interest rate for *Unsecured borrowings* (calculated including issue cost amortization) was 8.49% during the quarter and nine months ended September 30, 2009.

**NOTE 8 COMPREHENSIVE INCOME (LOSS)**

Comprehensive income (loss) is net income plus other comprehensive income (loss). Other comprehensive income (loss) currently consists of the change in unrealized gain on mortgage securities classified as available-for-sale and amounts related to Derivatives held as cash flow hedges. As of September 30, 2009, the *Accumulated other comprehensive income (loss)* component of *Stockholders' equity* consisted of \$167.4 million in net unrealized gains on mortgage securities held available-for-sale, \$19.4 million in net unrealized losses on Derivatives held as cash flow hedges and the \$381,000

**Table of Contents**

amortized balance of a realized loss offset by \$47,000 in realized gains, both related to terminated cash flow hedges. The following provides information regarding the components of comprehensive income (loss) (in thousands):

	<i>Quarter Ended</i>		<i>Nine Months Ended</i>	
	<i>September 30</i>	<i>September 30</i>	<i>September 30</i>	<i>September 30</i>
	<i>2009</i>	<i>2008</i>	<i>2009</i>	<i>2008</i>
Net income	\$ 42,085	\$ 34,746	\$ 126,668	\$ 101,621
Other comprehensive income (loss):				
Amounts related to available-for-sale securities:				
Reclassification adjustments for amounts included in net income				1,408
Change in net unrealized gains	30,680	(23,440)	157,262	(22,933)
Amounts related to cash flow hedges:				
Change in net unrealized losses	(6,191)	(5,252)	(14,240)	(8,357)
Early termination of interest rate swap agreement				(2,275)
Reclassification adjustment for amounts included in net income	15,900	4,092	42,102	7,599
Other comprehensive income (loss)	40,389	(24,600)	185,124	(24,558)
Comprehensive income (loss)	\$ 82,474	\$ 10,146	\$ 311,792	\$ 77,063

**NOTE 9 DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS**

The following tables and related discussion provide fair value disclosures as of the indicated balance sheet dates for Capstead's financial assets and liabilities, most of which are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management. Excluded from these disclosures are financial instruments for which the Company's cost basis is deemed to approximate fair value due primarily to the short duration of these instruments, including *Cash and cash equivalents*, *Cash collateral receivable from interest rate swap counterparties*, receivables, payables and borrowings under repurchase arrangements with initial terms of 120 days or less.

The Company's holdings of residential mortgage securities, nearly all of which are classified as held available-for-sale, are measured at fair value on a recurring basis using Level Two Inputs in accordance with ASC 820-10-35. In determining fair value estimates for mortgage securities the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for repurchase arrangements, provided such pricing levels are considered indicative of actual market clearing transactions.

Fair values for commercial loans are estimated using valuation techniques that involve uncertainties and are affected by assumptions used and judgments made regarding risk characteristics, discount rates, future cash flows, future loss expectations, and other factors, i.e., Level Three Inputs in accordance with ASC 820-10-35. Fair values of commercial securities are estimated based on the prices of other like-rated notes of similar maturities, considering the coupon interest rate and limited marketability of these securities, i.e., Level Two Inputs in accordance with ASC 820-10-35. In estimating the fair value of its commercial loans and securities the Company used discount rates of 10 to 25% to determine the net present value of related future cash flows. Fair values of borrowings under repurchase arrangements with initial terms of greater than 120 days and *Unsecured borrowings* are estimated based on offer prices for similar financial instruments or market positions, i.e., Level Two Inputs in accordance with ASC 820-10-35. See NOTE 6 for information relative to the valuation of interest rate swap agreements.



**Table of Contents**

Fair value disclosures for financial instruments other than debt securities were as follows (in thousands):

	<i>September 30, 2009</i>		<i>December 31, 2008</i>	
	<i>Carrying Amount</i>	<i>Fair Value</i>	<i>Carrying Amount</i>	<i>Fair Value</i>
Financial assets:				
Residential mortgage loans	\$ 12,301	\$ 12,400	\$ 15,004	\$ 15,000
Commercial loans	43,369	26,100	43,163	25,500
Interest rate swap agreements	43	43		
Financial liabilities:				
Repurchase arrangements with initial terms of greater than 120 days			1,127,420	1,142,900
Unsecured borrowings	103,095	100,700	103,095	85,900
Interest rate swap agreements	20,472	20,472	46,679	46,679

Fair value disclosures for debt securities were as follows (in thousands):

	<i>Basis</i>	<i>Gross Unrealized</i>		<i>Fair Value</i>
		<i>Gains</i>	<i>Losses</i>	
<i>As of September 30, 2009</i>				
Agency Securities classified as available-for-sale	\$7,676,373	\$167,873	\$ 439	\$7,843,807
Residential mortgage and commercial securities classified as held-to-maturity	21,001	461	67	21,395
<i>As of December 31, 2008</i>				
Agency Securities classified as available-for-sale	\$7,416,520	\$ 49,904	\$39,732	\$7,426,692
Residential mortgage securities classified as held-to-maturity	14,390	332		14,722

Additional disclosures for debt securities in an unrealized loss position were as follows (in thousands):

	<i>September 30, 2009</i>		<i>December 31, 2008</i>	
	<i>Fair Value</i>	<i>Unrealized Loss</i>	<i>Fair Value</i>	<i>Unrealized Loss</i>
Securities in an unrealized loss position:				
One year or greater	\$ 111,729	\$ 338	\$ 157,675	\$ 2,454
Less than one year	66,429	168	2,762,619	37,278
	\$ 178,158	\$ 506	\$ 2,920,294	\$ 39,732

Managing a leveraged portfolio of primarily ARM Agency Securities is the core focus of Capstead's investment strategy and management expects these securities will be held until payoff absent a major shift in the Company's investment focus. Declines in fair value caused by increases in interest rates are typically modest for investments in relatively short-duration ARM Agency Securities compared to investments in longer-duration, fixed-rate assets. These declines are generally recoverable in a relatively short period of time as the coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment allowing for the potential

recovery of financing spreads diminished during periods of rising interest rates.

From a credit risk perspective, the real or implied federal government guarantee associated with Agency Securities, particularly in light of the September 2008 conservatorship of the GSEs and other government support for these entities, helps ensure that fluctuations in value due to credit risk associated with these securities will be limited. Additionally, this support for the GSEs and other government actions to support the global financial system and improve market conditions has dramatically improved market liquidity for leveraged holders of Agency Securities compared to conditions existing late in 2008 in the

-15-

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**Table of Contents**

aftermath of the Lehman Brothers Holdings, Inc. bankruptcy. Given that (a) any existing unrealized losses on mortgage securities held by the Company are not attributable to credit risk, (b) the Company typically holds its investments to maturity, and (c) it is more likely than not that the Company will not be required to sell any of its investments, none of these investments are considered other-than-temporarily impaired at September 30, 2009. During the quarter ended March 31, 2008, the Company sold Agency Securities classified as available-for-sale with a cost basis of \$768 million recognizing a net loss of \$1.4 million (gross realized losses of \$2.7 million, and gross realized gains of \$1.3 million) included in *Miscellaneous other revenue (expense)*. No asset sales occurred during the quarter and nine months ended September 30, 2009.

**NOTE 10 COMPENSATION PROGRAMS**

The compensation committee of Capstead's board of directors administers all compensation programs for officers and employees including salaries, annual incentive compensation and long-term equity-based awards, as well as other benefit programs.

***Performance-based Cash Compensation Program to Augment Base Salaries***

To augment base salaries of certain executive officers, in 2008 the committee implemented a performance-based cash compensation program that provides for payments equal to the per share dividend declared on the Company's common stock multiplied by a notional amount of non-vesting or phantom common shares ( Dividend Equivalents ). Dividend Equivalents are not attached to any stock or option awards and only have the right to receive the same cash distributions as the Company's common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. In implementing this program, initial Dividend Equivalents for 225,000 phantom common shares with terms ending on July 1, 2012 were granted to certain executive officers in July 2008. On July 14, 2009, these officers received additional grants for 225,000 phantom common shares, also with terms ending July 1, 2012. During the quarter and nine months ended September 30, 2009, the Company recognized in *General and administrative expense* \$252,000 and \$509,000 related to this program, respectively.

***Annual Incentive Compensation***

To provide officers and employees with an appropriate performance-based annual incentive compensation opportunity, each year the committee approves an incentive formula to create an incentive pool equal to a percentage participation in the Company's earnings in excess of a pre-established performance threshold. The committee has complete discretion with respect to the amount to be distributed from the pool, including its allocation between executive officers and other employees. Approved distributions are typically made subsequent to year-end. The committee used its discretion to limit the total amount of annual incentive compensation awarded for the year ended December 31, 2008 to \$6.0 million.

For 2009 the committee modified the formula for determining the incentive pool and established a guideline for determining the maximum amount available to be paid in any single year equal to 50 basis points multiplied by average long-term investment capital, as defined. For purposes of the 2009 calculation, the incentive pool will equal a 10% participation in annual earnings (defined as *Net income* excluding *Incentive compensation expense*, any gain or loss from portfolio restructurings and interest on *Unsecured borrowings*, net of equity in the earnings of related statutory trusts reflected in the balance sheet as *Investments in unconsolidated affiliates*) in excess of a benchmark amount based on average long-term investment capital (defined as *Unsecured borrowings*, net of related investments in statutory trusts and average *Stockholders' equity*, excluding *Accumulated other comprehensive income (loss)*, incentive compensation accruals, any gain or loss from portfolio restructurings and interest on *Unsecured borrowings*, net of equity in the earnings of related statutory trusts) multiplied by the greater of 8.00% or

**Table of Contents**

the average 10-year U.S. Treasury rate plus 200 basis points. During the quarter and nine months ended September 30, 2009, the Company recognized *Incentive compensation expense* of \$1.1 million and \$3.4 million, respectively; the accrual for which is included in *Accounts payable and accrued expenses*.

**Long-term Equity-based Awards**

The Company sponsors equity-based award plans to provide for the issuance of stock awards, option awards and other long-term equity-based awards to directors and employees (collectively, the Plans). As of September 30, 2009, the Plans had 1,608,549 common shares remaining available for future issuance.

Service-based stock awards issued to directors and employees that vest in annual installments in 2009 and future years, subject to certain restrictions (principally continuous service), were as follows as of September 30, 2009:

<i>Year of Grant</i>	<i>Grant Date Fair Value Per Share</i>	<i>Total Original Grants</i>	<i>Shares Vesting In:</i>						
			<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	
2005	\$ 7.86	172,600	35,100						
2006	8.06	218,957	48,126	44,374	44,374				
2007	12.93	156,000	24,672	23,672	23,665	23,665	23,663	23,663	
2008	12.87	6,000	6,000						
2009	11.39	6,000		6,000					

In 2008, the Company began implementing a performance-based stock award program in lieu of its previous practice of issuing service-based awards to employees. In December 2008 the first grants totaling 140,658 common shares were issued to employees (grant date fair value \$10.18). The first 50% of these awards vest provided certain performance criteria pertaining to a three-year measurement period ending December 31, 2011 are met. The remaining 50% vests provided performance criteria pertaining to a three-year measurement period ending December 31, 2012 are met. If the performance criteria are not met at the end of a three-year measurement period, vesting will be deferred and a new three-year measurement period will be established to include the subsequent year, up to and including the year 2015. Any remaining unvested awards will expire if the performance criteria for the final three-year measurement period ending December 31, 2015 are not met. The performance criteria establishes an annualized threshold return on the Company's long-term investment capital, subject to certain adjustments, of the greater of 8.0% or the average 10-year U.S. Treasury rate plus 200 basis points that must be exceeded for the awards to vest.

Total stock award activity for the nine months ended September 30, 2009 is summarized below:

	<i>Number of Shares</i>	<i>Weighted Average Grant Date Fair Value</i>
Stock awards outstanding at December 31, 2008	479,132	\$ 10.30
Grants	6,000	11.39
Forfeitures	(17,500)	9.19
Vestings	(113,898)	9.39
Stock awards outstanding at September 30, 2009	353,734	10.66

During the quarter and nine months ended September 30, 2009, the Company recognized in *General and administrative expense* \$238,000 and \$800,000 related to stock awards, respectively. Unrecognized compensation

expense for unvested stock awards totaled \$3.0 million as of September 30, 2009, to be expensed over a weighted average period of 2.1 years.

-17-

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**Table of Contents**

Option awards currently outstanding have contractual terms and vesting requirements at the grant date of up to ten years and generally have been issued with strike prices equal to the quoted market prices of the Company's common shares on the date of grant. The fair value of each option award is estimated on the date of grant using a Black-Scholes option pricing model. The Company estimates option exercises, expected holding periods and forfeitures based on past experience and current expectations for option performance and employee or director attrition. Risk-free rates are based on market rates for the expected life of the option. Expected dividends are based on historical experience and expectations for future performance. Expected volatility factors are based on historical experience.

Option awards issued to directors and employees that vest in annual installments in 2009 and future years, subject to certain restrictions (principally continuous service), were as follows as of September 30, 2009:

<i>Year of Grant</i>	<i>Grant Date Fair Value Per Share*</i>	<i>Strike Price</i>	<i>Total Original Grants</i>	<i>Remaining Shares Vesting In:</i>		
				<i>2009</i>	<i>2010</i>	<i>2011</i>
2005	\$0.61	\$ 7.85	430,000	71,875		
2006	0.78	7.43	258,000	36,000	36,000	
2007	0.89	10.46	220,500	40,750	40,750	40,750
2008	2.08	12.87	30,000	30,000		
2009	1.52	11.69	30,000		30,000	

\* Based on volatility factors of 27%, 31%, 27%, 50% and 51% for years 2005, 2006, 2007, 2008 and 2009, respectively; dividend yields of 10% for years 2005 through 2007, 12% for 2008 and 14% for 2009; risk-free rates of 3.76%, 4.91%, 4.60%, 2.91% and 1.70% for years 2005, 2006, 2007, 2008 and 2009, respectively; and four year expected terms.

Option award activity for the nine months ended September 30, 2009 is summarized below:

	<i>Number of Shares</i>	<i>Weighted Average Exercise Price</i>
Option awards outstanding at December 31, 2008	555,750	\$ 9.12
Grants	30,000	11.69
Forfeitures	(43,750)	8.43
Exercises	(246,375)	7.95
Option awards outstanding at September 30, 2009	295,625	10.46

Exercisable option awards outstanding as of September 30, 2009 totaled 148,125 common shares and had a weighted average remaining contractual term of 7.4 years, an average exercise price of \$10.93 and aggregate intrinsic value of \$447,000. The total intrinsic value of option awards exercised during the quarter and nine months ended September 30, 2009 was \$1.1 million and \$1.4 million, respectively. During the quarter and nine months ended September 30, 2009, the Company recognized in *General and administrative expense* \$15,000 and \$50,000 related to option awards, respectively. Unrecognized compensation costs for unvested option awards totaled \$55,000 as of September 30, 2009, to be expensed over a weighted average period of 0.9 years.

***Other Benefit Programs***

Capstead sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its officers. In general the Company matches up to 50% of a participant's voluntary contribution up to a maximum of 6% of a participant's compensation and discretionary contributions of up to another 3% of compensation regardless of participation in the plans. Company contributions are subject to certain vesting requirements. During the quarter and nine months ended September 30, 2009, the Company recognized in *General and administrative expense* \$101,000 and \$296,000 related to contributions to these plans, respectively.

**Table of Contents****NOTE 11 NET INTEREST INCOME ANALYSIS**

The following summarizes interest income, interest expense and weighted average interest rates as well as related changes in interest income and interest expense due to changes in interest rates versus changes in volume (dollars in thousands):

	<i>Quarter Ended September 30</i>		<i>2008</i>		<i>Related Changes in</i>		
	<i>2009</i>	<i>Average</i>	<i>2008</i>	<i>Average</i>	<i>Rate*</i>	<i>Volume*</i>	<i>Total*</i>
	<i>Amount</i>	<i>Rate</i>	<i>Amount</i>	<i>Rate</i>			
Interest income:							
Mortgage securities and similar investments	\$ 74,695	3.95%	\$ 99,205	5.00%	\$ (20,028)	\$ (4,482)	\$ (24,510)
Other	69	0.25	346	2.31	(442)	165	(277)
	74,764	3.90	99,551	4.98	(20,470)	(4,317)	(24,787)
Interest expense:							
Repurchase arrangements and similar borrowings	(26,802)	1.55	(60,032)	3.26	(29,178)	(4,052)	(33,230)
Unsecured borrowings	(2,186)	8.49	(2,186)	8.49			
	(28,988)	1.65	(62,218)	3.34	(29,178)	(4,052)	(33,230)
	\$ 45,776	2.25	\$ 37,333	1.64	\$ 8,708	\$ (265)	\$ 8,443

	<i>Nine Months Ended September 30</i>		<i>2008</i>		<i>Related Changes in</i>		
	<i>2009</i>	<i>Average</i>	<i>2008</i>	<i>Average</i>	<i>Rate*</i>	<i>Volume*</i>	<i>Total*</i>
	<i>Amount</i>	<i>Rate</i>	<i>Amount</i>	<i>Rate</i>			
Interest income:							
Mortgage securities and similar investments	\$ 243,641	4.30%	\$ 302,888	5.32%	\$ (57,791)	\$ (1,456)	\$ (59,247)
Other	419	0.46	1,932	3.00	(2,089)	576	(1,513)
	244,060	4.24	304,820	5.30	(59,880)	(880)	(60,760)
Interest expense:							
Repurchase arrangements and similar borrowings	(98,385)	1.92	(184,357)	3.49	(79,832)	(6,140)	(85,972)
	(6,560)	8.49	(6,560)	8.49			



Unsecured  
borrowings

(104,945)	2.01	(190,917)	3.56	(79,832)	(6,140)	(85,972)
\$ 139,115	2.23	\$ 113,903	1.74	\$ 19,952	\$ 5,260	\$ 25,212

\* *The change in interest income and interest expense due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.*

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS  
FINANCIAL CONDITION**

***Overview***

Capstead Mortgage Corporation (together with its subsidiaries, Capstead or the Company) operates as a self-managed real estate investment trust for federal income tax purposes (a REIT) and is based in Dallas, Texas. Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored entities, either Fannie Mae or Freddie Mac (the GSEs), or by an agency of the federal government, Ginnie Mae.

Agency-guaranteed mortgage securities (Agency Securities), carry an implied AAA rating with limited, if any, credit risk. Management believes this strategy can produce attractive risk-adjusted returns over the long term while substantially eliminating credit risk and reducing, but not eliminating, sensitivity to changes in interest rates.

Capstead typically finances its investments with its long-term investment capital, which consists of common stockholders' equity together with \$179 million of perpetual preferred stockholders' equity (recorded amount) and \$100 million of long-term unsecured borrowings (net of related investments in statutory trusts) supported by its borrowings under repurchase arrangements with commercial banks and other financial institutions. During the nine months ended September 30, 2009, the Company's long-term investment capital increased by \$266 million to \$1.13 billion, due largely to increases in fair value of the Company's holdings of Agency Securities, along with improved interest rate swap valuations and accretion from capital raises. Together, these factors resulted in a decline in portfolio leverage (borrowings under repurchase arrangements divided by long-term investment capital) from 7.85 to one at year-end to 6.21 to one as of September 30, 2009. Pricing for Agency Securities has benefited from efforts by the federal government to support lower mortgage interest rates and improve overall liquidity in the residential mortgage market. The Company's mortgage securities and similar investments portfolio totaled \$7.92 billion at September 30, 2009, an increase of \$421 million from year-end.

Capstead earned \$42 million and \$127 million during the quarter and nine months ended September 30, 2009 compared to \$35 million and \$102 million during the same periods in 2008 primarily as a result of increased total financing spreads (the difference between yields on the Company's interest-earning assets and rates on interest-bearing liabilities). Total financing spreads averaged 225 basis points during the current quarter, compared to 164 basis points during the same period in 2008, benefiting from significantly lower borrowing rates primarily attributable to lower short-term interest rates.

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

***Risk Factors and Critical Accounting Policies***

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

**Table of Contents****Capital Raising Activity**

During the quarter and nine months ended September 30, 2009 Capstead issued 5,147,000 and 5,835,000 common shares at average prices of \$14.00 and \$13.82 per share (\$13.85 and \$13.66 per share, net of expenses), respectively, under the Company's continuous offering program. These issuances raised \$71 million and \$80 million in new common equity capital, after underwriting discounts and offering expenses, respectively. The Company may raise more capital in future periods, subject to market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important company-specific news.

**Book Value per Common Share**

Nearly all of Capstead's mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company's balance sheet and are therefore included in the calculation of book value per common share (total stockholders' equity, less liquidation preferences of the Company's Series A and B preferred shares, divided by common shares outstanding). The fair value of these positions is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels. The Company's investment strategy attempts to mitigate these risks by focusing almost exclusively on investments in Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans that have interest rates that reset periodically to more current levels. Because of these characteristics, the fair value of Capstead's portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to portfolios that contain a significant amount of non-agency and/or fixed-rate mortgage securities of any type, which generally results in a more stable book value per common share. The following table progresses book value per common share for the periods indicated:

	<i>March</i>	<i>Quarter Ended</i>		<i>Nine</i>
	<i>30</i>	<i>June 30</i>	<i>September</i>	<i>Months</i>
			<i>30</i>	<i>Ended</i>
				<i>September</i>
				<i>30</i>
Book value per common share, beginning of period	\$ 9.14	\$ 10.34	\$ 11.48	\$ 9.14
Accretion attributed to capital transactions	0.01	0.02	0.17	0.38
Earnings in excess of dividend distributions	0.02	0.01		0.01
Dividend distributions in excess of earnings			(0.02)	
Improvement in value of mortgage securities classified as available-for-sale	1.04	0.96	0.44	2.28
Improvement in value of interest rate swap Agreements designated as cash flow hedges	0.13	0.15	0.14	0.40
Book value per common share, end of period	\$ 10.34	\$ 11.48	\$ 12.21	\$ 12.21
Increase in book value for the indicated period	\$ 1.20	\$ 1.14	\$ 0.73	\$ 3.07

**Residential Mortgage Investments**

Managing a large portfolio of residential mortgage investments consisting primarily of ARM Agency Securities is the core focus of Capstead's investment strategy. As of September 30, 2009, residential mortgage investments totaled \$7.87 billion, consisting of over 99% ARM Agency Securities. This compares with residential mortgage investments totaling \$7.46 billion as of December 31, 2008. Non-agency-guaranteed residential mortgage investments held by Capstead were limited to \$16 million as of September 30, 2009 consisting of well-seasoned, low loan-to-value mortgage loans remaining from a conduit operation operated by the Company in the early 1990's. The Company holds the related credit risk associated with \$12 million of these loans, with the remainder held as collateral for structured

financings whereby the related credit risk is borne by the securitizations bondholders.

-21-

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**Table of Contents**

Agency Securities carry an implied AAA rating with limited, if any, credit risk because the timely payment of principal and interest is guaranteed by the GSEs, which are federally chartered corporations, or an agency of the federal government, Ginnie Mae. The September 2008 conservatorship of the GSEs by their federal regulator, and related capital commitments to the GSEs made by the U.S. Treasury, have served to largely alleviate market concerns regarding the ability of the GSEs to fulfill their guarantee obligations. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration, fixed-rate assets. These declines are generally recoverable in a relatively short period of time as the coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment allowing for the potential recovery of financing spreads diminished during periods of rising interest rates.

ARM securities are backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate ( CMT ) or the one-year London interbank offered rate ( LIBOR ), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indexes such as one-month LIBOR or the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the loans. The Company classifies its ARM securities based on each security's average number of months until coupon reset ( months-to-roll ). Current-reset ARM securities have a months-to-roll of 18 months or less while longer-to-reset ARM securities have a months-to-roll of greater than 18 months. As of September 30, 2009, the Company's ARM securities featured the following characteristics (dollars in thousands):

<i>ARM Type</i>	<i>Basis<sup>(a)</sup></i>	<i>Net WAC<sup>(b)</sup></i>	<i>Fully Indexed WAC<sup>(b)</sup></i>	<i>Average Net Margins</i>	<i>Average Periodic Caps</i>	<i>Average Lifetime Caps</i>	<i>Months To Roll</i>
Current-reset ARMs:							
Agency Securities:							
Fannie Mae/Freddie Mac	\$ 5,338,114	3.77%	2.54%	1.81%	3.37%	10.46%	5.2
Ginnie Mae	346,741	4.22	1.91	1.53	1.00	10.01	5.3
Residential mortgage loans	8,558	4.41	2.67	2.05	1.53	11.13	4.5
	5,693,413	3.80	2.50	1.80	3.22	10.44	5.2
Longer-to-reset ARMs:							
Agency Securities:							
Fannie Mae/Freddie Mac	1,991,317	6.15	2.58	1.66	1.97	11.57	29.1
	\$ 7,684,730	4.41	2.52	1.76	2.90	10.73	11.4

(a) *Basis represents the Company's investment*

*(unpaid principal balance plus unamortized investment premium) before unrealized gains and losses. As of September 30, 2009, the ratio of basis to related unpaid principal balance for the Company's ARM securities was 101.33. This table excludes commercial investments, fixed-rate residential mortgage investments and collateral for structured financings.*

*(b) Net WAC, or weighted average coupon, is presented net of servicing and other fees and as such, represents the cash yield earned by the Company before amortization of investment premiums. Fully indexed WAC represents the coupon upon one or more resets using interest rate indexes as of September 30,*

*2009 and the  
applicable net  
margin.*

Capstead typically finances its residential mortgage investments using 30-day borrowings under uncommitted repurchase arrangements with commercial banks and other financial institutions that are re-established monthly, although terms on a portion of these borrowings may be extended at times to manage market liquidity conditions or to take advantage of attractive terms. Interest rates on these borrowings are based on prevailing rates corresponding to the terms of the borrowings. Prior to the market turmoil that began in August 2007, the Company routinely made use of longer-dated repurchase arrangements to mitigate exposure to higher short-term interest rates, particularly as it pertains to

-22-

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**Table of Contents**

investments in longer-to-reset ARM Agency Securities. The remaining \$557 million of these longer-term committed borrowings with an average interest rate of 5.17% matured in August 2009. The Company's borrowings under repurchase arrangements as of September 30, 2009 consisted of \$6.99 billion of primarily 30-day borrowings with 16 counterparties at average rates of 0.37%.

In November 2007 the Company began using two-year term, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements entered into with four large commercial banks in lieu of longer-term borrowings. Under the terms of the interest rate swap agreements held by Capstead as of September 30, 2009, the Company pays fixed rates of interest averaging 2.76% on notional amounts totaling \$2.80 billion with an average maturity of nine months, including agreements with notional amounts totaling \$900 million and average fixed rates of 4.03% that terminate in November and December 2009, \$800 million with average fixed rates of 2.84% that terminate during the quarter ended March 31, 2010; \$200 million with average fixed rates of 3.17% that terminate during the quarter ended June 30, 2010; and \$900 million with average fixed rates of 1.33% that terminate between January and September 2011. Variable payments received by the Company under these agreements provide an offset to interest accruing on a like amount of the Company's 30- to 90-day borrowings leaving the fixed-rate payments to be paid on the swap agreements as the Company's effective borrowing rate, subject to certain adjustments including the effects of measured hedge ineffectiveness and the spread between variable rates on the swap agreements and related actual borrowing rates.

After consideration of these swap positions, the Company's portfolio and related borrowings under repurchase arrangements had durations of approximately eight and four months, respectively, for a net duration gap of approximately four months. Duration is a measure of market price sensitivity to interest rate movements. For instance, a 12 month duration infers that a position should change in value by one percent with a one percent change in interest rates, subject to other market variables and changes in market conditions. The Company intends to continue to manage interest rate risk by utilizing suitable derivative financial instruments ( Derivatives ) such as interest rate swap agreements as well as longer-dated committed borrowings if available at attractive terms.

In response to deteriorating market conditions experienced the latter part of 2007 and in 2008, Capstead reduced its portfolio leverage during those periods by raising a significant amount of new common equity capital, selling a limited amount of Agency Securities and, when appropriate, curtailing the replacement of portfolio runoff. In addition, the Company increased the number of lending counterparties with which it uses on a regular basis. During 2009, the Company resumed its usual practice of replacing portfolio runoff and deploying new common equity capital into additional holdings of ARM Agency Securities, with a focus on acquiring current-reset ARM securities. Additionally, the Company has experienced a significant increase in the fair value of its portfolio. Year-to-date, acquisitions (consisting primarily of current-reset ARM Agency Securities) totaled \$1.31 billion in principal amount with a net WAC of 4.28% and a purchase yield of 2.95%, while portfolio runoff totaled \$1.07 billion in principal amount. Combined with a \$157 million improvement in pricing of Agency Securities classified as available-for-sale, the Company's holdings of residential mortgage investments increased \$411 million in 2009. Total runoff for residential mortgage investments increased during the current quarter to an average annualized rate of 21.7%, while averaging 17.6% year-to-date compared to 18.4% throughout 2008. While trending higher from near-record low levels experienced earlier this year, prepayment rates remain at relatively favorable levels and continue to be restrained by the pronounced contraction seen in residential mortgage lending, largely because of national trends toward declining home values and tighter mortgage loan underwriting standards. Since Capstead typically purchases investments at a premium to the asset's unpaid principal balance, high levels of mortgage prepayments can put downward pressure on ARM security yields because the level of mortgage prepayments impacts how quickly investment premiums are written off against earnings as portfolio yield adjustments.



**Table of Contents**

***Commercial Investments***

In prior years Capstead periodically augmented its core investment strategy with investments in credit-sensitive commercial real estate-related assets that could earn attractive risk-adjusted returns. In light of overall credit market conditions, in 2008 management concluded that it will not pursue additional investments in commercial real estate-related assets in order to focus its efforts on the Company's core portfolio of ARM Agency Securities. Investments in commercial loans and securities as of September 30, 2009 consisted of \$6.0 million in subordinated loans to a Dallas, Texas-based townhome developer expected to be repaid primarily through unit sales, \$38.4 million in subordinated loans collateralized by the Four Seasons hotel in Nevis, West Indies, and \$10.0 million face amount of AAA-rated senior notes issued by one of the Company's lending counterparties.

Regarding the townhome development loans, in January 2009 the Company began making advances for operating expenses on behalf of the borrower who is in financial difficulty. These advances totaled \$290,000 and \$880,000 for the quarter and nine months ended September 30, 2009. The Company curtailed recognizing interest on these loans effective January 1, 2009 and in June the Company recognized in *Miscellaneous other revenue (expense)* a \$750,000 impairment charge, increasing its allowance for possible loan losses to \$1.0 million, primarily because of slow sales and reduced pricing of units collateralizing the townhome development loans. No additional impairment charges were recognized during the quarter ended September 30, 2009 relative to this investment.

The financing for the Nevis property matured in October 2008 and one week later it was significantly damaged by Hurricane Omar, forcing closure of the hotel. The property has wind and business interruption insurance coverage, which together with related reserves, should be sufficient to fund most rebuilding and reopening costs necessary to reopen the hotel. In September 2009 the Company settled a legal dispute with a junior lien holder, subsequently dropped its lawsuit against the lien holder and the loan servicer and, pursuant to the settlement, is now acting as controlling holder representing the lending group. The Company is currently investigating the lending group's options for reopening the hotel and achieving an optimal recovery under the circumstances. On January 1, 2009 the Company curtailed recognizing interest and during 2009 no impairment charges have been recognized relative to this investment.

The senior notes were issued in July 2009 pursuant to a larger private placement by two large commercial banks of senior and junior notes of a lending counterparty. The notes, which bear interest at 10.0% per annum, payable monthly, mature on December 15, 2010 and are callable by the borrower at par.

***Utilization of Long-term Investment Capital and Potential Liquidity***

Capstead finances a majority of its holdings of residential mortgage securities with commercial banks and other financial institutions using borrowings under repurchase arrangements supported by the Company's long-term investment capital. Assuming potential liquidity is available, borrowings under repurchase agreements generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Consequently, the Company's potential liquidity inherent in its investment portfolios is as important as the actual level of cash and cash equivalents carried on the balance sheet. Potential liquidity is affected by, among other things, changes in market value of assets pledged as determined by lending counterparties; principal prepayments; collateral requirements of lenders; and general conditions in the commercial banking and mortgage finance industries. Future levels of portfolio leverage will be dependent upon many factors, including the size and composition of the Company's investment portfolio (see *Liquidity and Capital Resources* ).

**Table of Contents**

Capstead's utilization of long-term investment capital and its estimated potential liquidity were as follows as of September 30, 2009 in comparison with December 31, 2008 (in thousands):

	<i>Investments<sup>(a)</sup></i>	<i>Related Borrowings</i>	<i>Capital Employed<sup>(a)</sup></i>	<i>Potential Liquidity<sup>(a)</sup></i>
Mortgage securities and similar investments	\$ 7,920,478	\$ 6,992,755	\$ 927,723	\$ 456,540
Other assets, net of other liabilities			237,681	168,496
Third quarter common dividend			(38,695)	(38,695)
			\$ 1,126,709	\$ 586,341
Balances as of December 31, 2008	\$ 7,499,249	\$ 6,751,500	\$ 860,428	\$ 302,931

(a) *Investments are stated at carrying amounts on the Company's balance sheets. Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted repurchase arrangements considering management's estimate of the fair value of related collateral as of the indicated dates adjusted for other sources (uses) of liquidity such as cash and cash equivalents and dividends payable.*

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund margin calls (requirements to pledge additional collateral or pay down borrowings), including margin calls resulting from monthly principal payments (that are not remitted to the Company for 20 to 45 days after any given month-end), as well as anticipated declines in the market value of pledged assets under stressed market conditions.

In response to deteriorating market conditions experienced the latter part of 2007 and in 2008, Capstead reduced its portfolio leverage during these periods by raising new common equity capital, selling a limited amount of mortgage securities, and, when appropriate, curtailing the replacement of portfolio runoff. As a result of these efforts, the Company lowered its portfolio leverage from 11.50 to one at June 30, 2007 to 7.85 to one by December 31, 2008. Portfolio leverage declined further to 6.21 to one by September 30, 2009, due largely to increases in the fair value of the Company's holdings of Agency Securities, along with improved interest rate swap valuations and accretion from capital raises. Together with maintaining higher than usual cash balances and expanding the number of lending counterparties with whom the Company routinely does business, these steps have increased the Company's financial flexibility to address challenging market conditions. Management currently believes it is appropriate to maintain the Company's leverage below the low end of its targeted range of eight to 12 times long-term investment capital and will take actions similar to those described above in order to maintain sufficient financial flexibility should market conditions warrant.

#### ***Recent Accounting Developments***

In June 2008, the Financial Accounting Standards Board ( FASB ) issued Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (now referred to as ASC 260-10-45 under the FASB Accounting Standards Codification or ASC ). This pronouncement affects entities that accrue cash dividends on share-based payment awards during the awards' service period when the dividends do not need to be returned if any holder forfeits an award. The FASB concluded that unvested share-based payment awards that contain rights to non-forfeitable dividends are participating securities (i.e. the holders participate in dividends with common stockholders) and must be included in computing basic and diluted earnings per share, if dilutive. ASC 260-10-45 became effective for financial statements beginning January 1, 2009 and requires an entity to retroactively adjust all prior period earnings per share computations to reflect its provisions. Adopting ASC 260-10-45 did not have a material impact on the Company's consolidated financial statements.

On January 1, 2009, Capstead adopted FASB Staff Position FAS140-3 *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* ( ASC 860-10-40 ). Under ASC 860-10-40, certain seller-financed acquisitions of mortgage investments entered into after December 31, 2008 will

**Table of Contents**

not qualify as acquisitions if the related borrowings under repurchase arrangements are considered sufficiently linked to the acquisition transaction. Any such seller-financed acquisitions that are deemed to be sufficiently linked will generally be reported net of related financings at fair value with related changes in fair value reported in earnings until such time as the assets are no longer financed with the sellers. No such linked acquisitions have occurred during the quarter and nine months ended September 30, 2009; therefore, implementing ASC 860-10-40 has not had any impact on the Company's consolidated financial statements.

In April 2009, the FASB issued three concurrent Staff Positions: (i) Staff Position No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, (ii) Staff Position No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for an Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (collectively, these two pronouncements are referred to as ASC 820-10-35 ) and (iii) Staff Position No. FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments* ( ASC 825-10-50 ). ASC 320-10-35 provides additional guidance for accounting for other-than-temporary impairments on debt securities. In addition to existing guidance, under ASC 320-10-35 an other-than-temporary impairment is deemed to exist if an entity does not expect to recover the entire amortized cost basis of a debt security. ASC 320-10-35 provides for the bifurcation of other-than-temporary impairments into (i) amounts related to credit losses, which are recognized through earnings, and (ii) amounts related to all other factors, which are recognized as a component of Other comprehensive income (loss). Further, ASC 320-10-35 requires certain additional disclosures for debt securities. Finally, ASC 820-10-35 provides additional guidance in determining if the market for an asset or liability is inactive and, accordingly, if quoted market prices may not be indicative of fair value. ASC 825-10-50 extends existing annual financial instrument fair value disclosure requirements to interim periods. All three of these pronouncements were effective for periods ending after June 15, 2009 and were required to be implemented concurrently. Accordingly, Capstead adopted these pronouncements on April 1, 2009. The adoption did not have any impact on the Company's consolidated financial statements.

In May 2009, the FASB issued statement No. 165, *Subsequent Events* ( Subsequent Events Topic 855 or ASC 855 ). ASC 855 modifies the definition of what qualifies as a subsequent event—those events or transactions that occur following the balance sheet date, but before the financial statements are issued, or are available to be issued—and requires companies to disclose the date through which it has evaluated subsequent events and the basis for determining that date. ASC 855 is effective for periods ending after June 15, 2009. Accordingly, Capstead adopted the standard during the quarter ended June 30, 2009. The adoption of ASC 855 did not have any impact on the Company's consolidated financial statements. In preparing the accompanying consolidated financial statements, the Company has reviewed events that have occurred after September 30, 2009, up until the time of issuance of the financial statements on November 4, 2009.

Although the Company's commercial real estate-related investments are considered variable interests in the entities that own the underlying real estate, Capstead was not considered the primary beneficiary when these investments were made because of the substantial amounts of borrower equity at risk at origination. Although both borrowers are currently in default (See NOTE 4), no events have occurred through September 30, 2009 that would require reconsideration of whether the borrower was still the primary beneficiary under current GAAP. Therefore, these entities remain unconsolidated. In June 2009, the FASB issued statement No. 167, *Amendments to FASB Interpretation No. 46(R)* ( ASC 810-10-25 ). Among other items, ASC 810-10-25 responds to concerns about the application of certain key provisions of the previous pronouncement, including those regarding the transparency of the involvement with variable interest entities. ASC 810-10-25 is effective for calendar year companies beginning on January 1, 2010. Although the adoption of this statement is expected to result in the consolidation of one of these investments (the townhome development loans), this is not expected to have a material impact on the Company's consolidated financial statements.

**Table of Contents****RESULTS OF OPERATIONS**

	<i>Quarter Ended</i>		<i>Nine Months</i>	
	<i>September 30</i>		<i>Ended September 30</i>	
	<i>2009</i>	<i>2008</i>	<i>2009</i>	<i>2008</i>
<b>Income statement data</b> ( <i>dollars in thousands, except per share data</i> ):				
Interest income:				
Mortgage securities and similar investments	\$ 74,695	\$ 99,205	\$ 243,641	\$ 302,888
Other	69	346	419	1,932
	74,764	99,551	244,060	304,820
Interest expense:				
Repurchase arrangements and similar borrowings	(26,802)	(60,032)	(98,385)	(184,357)
Unsecured borrowings	(2,186)	(2,186)	(6,560)	(6,560)
	(28,988)	(62,218)	(104,945)	(190,917)
	45,776	37,333	139,115	113,903
Other revenue (expense):				
Miscellaneous other revenue (expense)	16	(45)	(893)	(1,469)
Incentive compensation expense	(1,058)	(300)	(3,435)	(4,820)
General and administrative expense	(2,713)	(2,306)	(8,313)	(6,187)
	(3,755)	(2,651)	(12,641)	(12,476)
	42,021	34,682	126,474	101,427
Equity in earnings of unconsolidated affiliates	64	64	194	194
Net income	\$ 42,085	\$ 34,746	\$ 126,668	\$ 101,621
Net income available to common stockholders, after preferred share dividends	\$ 37,027	\$ 29,684	\$ 111,488	\$ 86,432
Diluted earnings per common share	\$ 0.56	\$ 0.52	\$ 1.71	\$ 1.63
Average diluted shares outstanding:	75,436	56,737	73,798	61,998
<b>Key portfolio statistics</b> ( <i>dollars in millions</i> ):				
Average yields:				
Mortgage securities and similar investments	3.95%	5.00%	4.30%	5.32%
Other	0.25	2.31	0.46	3.00
Total average yields	3.90	4.98	4.24	5.30
Average borrowing rates:				
Repurchase arrangements and similar borrowings	1.55	3.26	1.92	3.49
Unsecured borrowings	8.49	8.49	8.49	8.49
Total borrowing rates	1.65	3.34	2.01	3.56
Total financing spreads	2.25	1.64	2.23	1.74

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Net yield on total interest-earning assets	2.37	1.86	2.42	1.98
Average portfolio runoff rate	21.60	19.12	17.46	19.51
Average basis in interest-earning assets and interest-bearing liabilities:				
Mortgage securities and similar investments	\$ 7,564	\$ 7,928	\$ 7,553	\$ 7,592
Other interest-earning assets	112	60	121	86
Repurchase arrangements and similar borrowings	6,785	7,196	6,771	6,942
Unsecured borrowings	103	103	103	103
Average long-term investment capital	1,076	873	1,000	812
General and administrative and incentive compensation expense as a percentage of average long-term investment capital	1.39%	1.19%	1.57%	1.81%
Return on average long-term investment capital	16.30	16.81	17.79	17.76
	-27-			

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**Table of Contents**

Capstead's net income totaled \$42 million and \$127 million during the quarter and nine months ended September 30, 2009, respectively, compared to \$35 million and \$102 million during the same periods in 2008 primarily as a result of increased net interest margins and financing spreads on mortgage securities and similar investments and other interest-earning assets. Net interest margins and financing spreads improved as declines in interest income and portfolio yields resulting from lower prevailing interest rates were more than offset by the effects of lower borrowing rates. Portfolio leverage declined from 7.85 to one at year-end to 6.21 to one by September 30, due largely to a significant increase in fair value of the Company's holdings of Agency Securities, along with improved interest rate swap valuations and accretion from capital raises. This compares to portfolio leverage of 9.84 to one at the beginning of 2008 that was reduced to 8.36 to one at September 30, 2008 primarily through capital raising activities and asset sales.

Total financing spreads averaged 225 and 223 basis points during the quarter and nine months ended September 30, 2009 compared to 164 and 174 basis points during the same periods in 2008, having benefited from lower borrowing rates primarily attributable to lower short-term interest rates prevailing during 2009. Average portfolio yields were 108 and 106 basis points lower during the quarter and nine months ended September 30, 2009 compared to the same periods in 2008 reflecting (a) lower yields on existing portfolio as coupon interest rates on the underlying mortgage loans continued resetting to rates more reflective of the current rate environment, (b) lower market yields on acquisitions and (c) the curtailment of interest accruals on commercial real estate-related investments. In addition, yields were impacted by lower yields on overnight investments and cash collateral receivables from swap counterparties also reflecting lower prevailing short-term interest rates. Mitigating these declines in yields were slower mortgage prepayments on a year-to-date basis reflecting the pronounced contraction seen in residential mortgage lending, largely because of national trends toward declining home values and tighter loan underwriting standards. Since Capstead typically purchases investments at a premium to the asset's unpaid principal balance, the level of mortgage prepayments impacts how quickly these investment premiums are written off against earnings as yield adjustments.

Average borrowing rates on interest-bearing liabilities declined 169 and 155 basis points during the quarter and nine months ended September 30, 2009 compared to the same periods in 2008. Approximately \$2.76 billion and \$2.94 billion of the Company's average borrowings during the quarter and nine months ended September 30, 2009 were relatively stable in terms of rate because of the use of interest rate swap agreements and longer-dated repurchase arrangements to manage interest rate risk. On a combined basis, rates on the Company's swap positions and longer-dated repurchase arrangements averaged 3.14% and 3.45% during these periods in 2009, respectively. Corresponding amounts in 2008 were \$3.36 billion and \$3.17 billion and 4.14% and 4.22%, respectively. The remainder of the Company's borrowings under repurchase arrangements typically reset in rate every 30 to 90 days as they are re-established at prevailing rates corresponding to the terms of the borrowings. Rates on these borrowings averaged 0.41% and 0.69% during the quarter and nine months ended September 30, 2009 compared to 2.52% and 2.90% during the same periods in 2008, benefiting from efforts by the Federal Reserve to support the economy and the credit markets by lowering its federal funds target rate from 5.25% in early September 2007 to 2.00% by September 30, 2008 and to its current target range of from zero to 0.25% in December 2008.

Miscellaneous other revenue (expense) includes a \$750,000 impairment charge recognized in June 2009 necessitated primarily by slower than anticipated sales of collateral backing townhome development loans. No impairment charges were recognized during the current quarter. As part of its efforts in 2008 to reduce portfolio leverage in the face of contracting market liquidity conditions, during March 2008 the Company sold ARM Agency Securities with a cost basis of \$768 million for a modest loss.

**Table of Contents**

Incentive compensation expense relates to the Company's annual incentive compensation program. For 2009 the compensation committee of the board modified the incentive compensation formula to, among other things, establish a guideline for determining a maximum amount available to be paid in any single year. As modified, the program provides for a 10% participation in annual earnings, as adjusted, in excess of a benchmark amount based on average long-term investment capital, after certain adjustments, multiplied by the greater of 8.0% or the average 10-year U.S. Treasury rate plus 200 basis points and subject to a maximum amount equal to 50 basis points of average long-term investment capital, as defined. A similar formula used in establishing annual incentive compensation in 2008 did not feature a guideline for a maximum amount to be paid. In September 2008, the committee used its discretion to limit the amount of annual incentive compensation to be awarded in 2008 to \$6 million. See NOTE 10 to the accompanying consolidated financial statements for additional information regarding the Company's compensation programs. General and administrative expense for the quarter and nine months ended September 30, 2009 increased over the same periods in 2008 primarily as a result of higher compensation and professional service-related costs in large part due to expansion of the Company's capital base and operating platform over the past two years, as well as adjustments made in the Company's compensation programs.

**LIQUIDITY AND CAPITAL RESOURCES**

Capstead's primary sources of funds are borrowings under repurchase arrangements and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity available under its borrowing arrangements is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under Financial Condition Utilization of Long-term Investment Capital and Potential Liquidity and accompanying discussion illustrates management's estimate of additional funds potentially available to the Company as of September 30, 2009 and its perspective on the appropriate level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments when considered appropriate, repayments on borrowings and the payment of cash dividends as required for Capstead's continued qualification as a REIT. It is the Company's policy to remain strongly capitalized and conservatively leveraged.

In response to the growth of Capstead's residential mortgage investments portfolio and to turbulent market conditions experienced in the recent past, the Company has pursued additional lending counterparties in order to further increase its financial flexibility and ability to withstand periods of contracting market liquidity. Currently the Company has uncommitted repurchase facilities with a variety of lending counterparties to finance its portfolio, subject to certain conditions, and had borrowings outstanding with 16 of these counterparties as of September 30, 2009, up from ten in September 2007. Borrowings under repurchase arrangements secured by residential mortgage investments totaled \$6.99 billion as of September 30, 2009, including \$5.29 billion with maturities of 30 to 90 days and \$1.70 billion that mature shortly after year-end. The last of the Company's longer-term committed repurchase arrangements entered into prior to the market turmoil that began in August 2007 matured in August 2009. Interest rates on borrowings under repurchase arrangements are generally based on prevailing rates at inception corresponding to the terms of the borrowings. All terms and conditions are negotiated on a transaction-by-transaction basis. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries.



**Table of Contents**

Late in 2007 Capstead began using two-year term, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements to mitigate exposure to higher short-term interest rates by effectively locking in fixed rates on a portion of its 30- to 90-day borrowings because longer-term committed borrowings were no longer available at attractive terms. As of September 30, 2009 these swap agreements had notional amounts totaling \$2.80 billion with an average maturity of nine months and were designated as cash flow hedges for accounting purposes of a like amount of the Company's 30 to 90 day borrowings. The Company intends to continue to manage interest rate risk by utilizing suitable Derivatives such as interest rate swap agreements.

In February 2008 Capstead completed its third public offering since October 2007 raising nearly \$127 million in new common equity capital, after underwriting discounts and offering expenses. In addition, during the year ended December 31, 2008 the Company raised \$154 million, after expenses, in new common equity capital under its continuous offering program. Continuous offering program issuances during the quarter and nine months ended September 30, 2009 totaled \$71 million and \$80 million, respectively. The Company may raise additional equity capital in future periods.

**Interest Rate Sensitivity on Operating Results**

Capstead performs income sensitivity analysis using an income simulation model to estimate the effects that specific interest rate changes can reasonably be expected to have on future earnings. All investments, borrowings and Derivatives held are included in this analysis. The sensitivity of components of other revenue (expense) to changes in interest rates is included as well, although no asset sales are assumed. The model incorporates management's assumptions regarding the level of mortgage prepayments for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity. Capstead had the following estimated income sensitivity profile as of September 30, 2009 and December 31, 2008, respectively (dollars in thousands):

	<i>Federal Funds Rate</i>	<i>10-year U.S. Treasury Rate</i>	<i>Immediate Change In:*</i>				
			Up	Up	Up	Up	
30-day to one-year rates		Flat	1.00%	1.00%	2.00%	3.00%	
		Down		Up	Up	Up	
10-year U.S. Treasury rate		1.00%	Flat	1.00%	2.00%	3.00%	
Projected 12-month income change:							
September 30, 2009	<0.25%	3.31%	\$(11,000)	\$(11,900)	\$ (6,400)	\$(19,600)	\$(37,400)
December 31, 2008	<0.25	2.21	(9,400)	(17,900)	(13,300)	(31,000)	(49,000)

\* *Sensitivity of earnings to changes in interest rates is calculated*

*based on actual rates on the indicated dates.*

*Projected 12-month earnings changes are predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices or if investments made will behave in the same fashion as assets currently held.*

Income simulation modeling is the primary tool used by management to assess the direction and magnitude of changes in net interest margins on investments resulting solely from changes in interest rates. Key assumptions in the model include mortgage prepayment rates, adequate levels of market liquidity, changes in market conditions, portfolio leverage levels, and management's investment capital plans. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate net interest margins or precisely predict the impact of higher or lower interest rates on net interest margins. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and other changes in market conditions, management strategies and other factors.

-30-

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**Table of Contents**

**RISK FACTORS**

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

***Risks Related to Capstead's Business***

*Potential changes in the relationship between the federal government and the GSEs could negatively affect Capstead's financial condition and earnings. Agency Securities have an implied AAA rating because the timely payment of principal and interest on these securities are guaranteed by the GSEs, or by an agency of the federal government, Ginnie Mae. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. As a result of the current housing downturn, the GSEs have reported substantial losses in recent quarters leading to concerns regarding their ability to fulfill their guarantee obligations. The conservatorship of the GSEs on September 7, 2008 by the Federal Housing Finance Agency and commitments made by the federal government to provide substantial financial backing in the form of preferred equity capital and temporary secured lending facilities, helped to alleviate these concerns. These and other steps being taken by the federal government, including the purchase of Agency Securities by the U.S. Treasury and the Federal Reserve, are designed to support market stability and mortgage availability by providing additional confidence to investors in Agency Securities during the current housing correction. There can be no assurance that the federal government's support for the GSEs and the market for Agency Securities will be adequate to achieve these goals. In addition, the timing of purchases (and any subsequent sales) of Agency Securities by the federal government could create volatility in the market pricing of these investments.*

*It is anticipated that over the next several years U.S. policy makers will address what the long-term role of the federal government in general, and the GSEs in particular, will play in the housing markets. The actual or perceived credit quality of Agency Securities could be negatively affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Ginnie Mae or the GSEs could negatively affect the credit profile and pricing of future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of Agency Securities remains viable.*

*Government-supported mortgagor relief programs and future legislative action could negatively affect Capstead's financial condition and earnings. U.S. policy makers have established or announced programs designed to provide certain qualified homeowners with assistance in avoiding foreclosure or in qualifying for the refinancing of their existing mortgages. These programs would typically entail the pay off of existing mortgages with any losses absorbed by the GSEs. In addition, policy makers have indicated support for additional legislative relief for homeowners, including amending bankruptcy laws to permit the modification of mortgage loans in bankruptcy procedures. These mortgagor relief programs, as well as any future legislative or regulatory actions, could significantly reduce the expected life of the Company's residential mortgage investments; therefore, actual yields the Company realizes on these investments could be lower due to faster amortization of investment premiums.*

*Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to the Company or the amounts individual counterparties are willing to lend via repurchase arrangements. Capstead will generally pledge its investments in mortgage securities as collateral under*

**Table of Contents**

uncommitted repurchase arrangements with numerous commercial banks and other financial institutions, routinely with maturities of 30 to 90 days. Many of the Company's counterparties have suffered losses in the current economic downturn and a number of counterparties have had to be completely replaced because they exited the securities lending business. The Company's ability to achieve its investment objectives depends on its ability to re-establish or roll maturing borrowings on a continuous basis. If a counterparty chooses not to roll a maturing borrowing, the Company must pay off the borrowing, generally with cash available from another repurchase arrangement entered into with another counterparty. If the Company deems it does not have sufficient borrowing capacity with its counterparties, it could be forced to reduce its portfolio leverage by selling assets under possibly adverse market conditions, which may adversely affect its profitability. This risk is increased if Capstead relies significantly on any single counterparty for a significant portion of its repurchase arrangements. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

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

*Periods of rising interest rates may reduce amounts available to be borrowed under Capstead's repurchase arrangements due to declines in the value of related collateral, which could negatively impact the Company's financial condition and earnings.* Because rising interest rates tend to put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. *If Capstead is unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of the Company's counterparties, the Company's financial condition and earnings could be negatively impacted.* The terms and conditions of each repurchase arrangement are negotiated on a transaction-by-transaction basis, and these borrowings generally are re-established, or rolled, at maturity. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on its future repurchase arrangements. Also, during periods of market illiquidity or due to perceived credit quality deterioration of the collateral pledged, a lender may require that less favorable asset pricing procedures be employed or the margin requirement be increased. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

**Table of Contents**

*Capstead's use of repurchase arrangements to finance its investments may give the Company's lenders greater rights in the event of bankruptcy.* Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy and subject to the Company losses. In addition, if the Company ever files for bankruptcy, its repurchase arrangement counterparties may be able to avoid the automatic stay provisions of the U.S. Bankruptcy Code and take possession of, and liquidate, the Company's collateral under these arrangements without delay, which could result in losses.

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

*Changes in interest rates, whether increases or decreases, may adversely affect Capstead's earnings.* Capstead's earnings currently depend primarily on the difference between the interest received on its mortgage securities and similar investments and the interest paid on its related borrowings. The Company typically finances its investments at 30- to 90-day interest rates. Because only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan, in a rising short-term interest rate environment, interest rates on related borrowings not hedged through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities, contributing to lower or even negative financing spreads and adversely affecting earnings. At other times, during periods of relatively low short-term interest rates, declines in the indices used to reset ARM loans may negatively affect yields on the Company's ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company's borrowing rates, earnings would be adversely affected. The average life of Capstead's longer-to-reset ARM securities could outstrip related fixed-rate borrowings. Longer-to-reset ARM securities held by Capstead consist almost exclusively of a combination of seasoned and relatively newly issued hybrid ARMs with initial coupon interest rates that are fixed for five years. Prior to changes in market conditions during the fall of 2007, Capstead made use of longer-dated repurchase arrangements to manage interest rate risk, particularly as it relates to its investments in longer-to-reset ARM Agency Securities. Late in 2007 the Company began using two-year term interest rate swap agreements for this purpose. In a rising interest rate environment, the weighted average life of the Company's longer-to-reset ARM securities could extend beyond the terms of related longer-dated borrowings and swap positions more than originally anticipated. This could have a negative impact on financing spreads and earnings as related borrowing costs would no longer be fixed during the remaining fixed-rate term of these investments and may also cause a decline in fair value of these assets without a corresponding increase in value from related longer-dated borrowings or swap positions.

*An increase in prepayments may adversely affect Capstead's earnings.* When short- and long-term interest rates are at nearly the same levels (i.e., a flat yield curve environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums.

*The lack of availability of suitable investments at attractive pricing may adversely affect Capstead's earnings.* Pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many

**Table of Contents**

of whom have greater financial resources and lower return requirements than Capstead. To the extent the proceeds from prepayments on Capstead's mortgage securities and similar investments are not reinvested or cannot be reinvested at a rate of return at least equal to the rate previously earned on those investments, the Company's earnings may be adversely affected. Similarly, if proceeds from capital raising activities, if any, are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can the Company assure investors that it will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

*Capstead may invest in Derivatives such as interest rate swap agreements to mitigate or hedge the Company's interest rate risk, which may negatively affect the Company's liquidity, financial condition or earnings.* The Company may invest in such instruments from time to time with the goal of achieving more stable financing spreads, particularly related to the longer-to-reset ARM securities component of its mortgage securities and similar investment portfolio. However, these activities may not have the desired beneficial impact on the Company's liquidity, financial condition or earnings. For instance, the pricing of ARM securities and the pricing of the related Derivatives may deteriorate at the same time leading to margin calls on both the borrowings supporting investments in ARM securities and the Derivatives, negatively impacting the Company's liquidity and stockholders' equity. In addition, counterparties could fail to honor their commitments under the terms of the Derivatives or have their credit quality downgraded impairing the value of the Derivatives. In the event of any defaults by counterparties, the Company may have difficulty recovering its collateral and may not receive payments provided for under the terms of the Derivatives. Should Capstead be required to sell its Derivatives under such circumstances, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

Derivatives held may fail to qualify for hedge accounting introducing potential volatility to Capstead's earnings. The Company typically qualifies Derivatives held as cash flow hedges for accounting purposes in order to record the effective portion of the change in fair value of Derivatives as a component of stockholders' equity rather than in earnings. If the hedging relationship for any Derivative held ceases to qualify for hedge accounting treatment for any reason, including failing documentation and ongoing hedge effectiveness requirements, the Company would be required to record in earnings the total change in fair value of any such Derivative. This could introduce a potentially significant amount of volatility to earnings reported by the Company.

*Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects.* As a self-managed REIT with fewer than 20 employees, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. Although most of the Company's named executive officers and many of its other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

*Commercial investments may expose investors to greater risks of loss than residential mortgage investments.* The repayment of a loan secured by an income-producing property is typically dependent upon the successful operation of the related real estate project and the ability of the applicable property to produce net operating income rather than upon the liquidation value of the underlying real estate. The repayment of loans secured by development properties is typically dependent upon the successful development of the property for its intended use and (a) the subsequent lease-up such that the development becomes a successful income-producing property or (b) the subsequent sale of some or all of the property for adequate consideration. In the event cash flows from operating or developing a

**Table of Contents**

commercial property are insufficient to cover all debt service requirements, junior liens generally absorb the shortfall. As a result, declines in current or anticipated cash flows, among other factors, can lead to declines in value of the underlying real estate large enough that the aggregate outstanding balances of senior and junior liens could exceed the value of the real estate. In the event of default, the junior lienholder may need to make payments on the senior loans to preserve its rights to the underlying real estate and prevent foreclosure. Because the senior lienholders generally have priority on proceeds from liquidating the underlying real estate, junior lienholders may not recover all or any of their investment.

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

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

The Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates.

Any resulting tax liability could be substantial and would reduce the amount of cash available for distribution to stockholders, and Capstead would not be required to make distributions of the Company's income.

Unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which the Company lost its qualification, and, thus, the Company's cash available for distribution to stockholders would be reduced for each of the years during which the Company did not qualify as a REIT.

*Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings.*

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

will be required to pay tax on any undistributed REIT taxable income,

may be required to pay the alternative minimum tax on any items of tax preference, and

may operate taxable REIT subsidiaries that are required to pay taxes on any taxable income earned.

*Complying with REIT requirements may cause Capstead to forego otherwise attractive opportunities.* To qualify as a REIT for federal income tax purposes, Capstead must continually satisfy tests concerning, among other things, the sources of its income, the nature and diversification of its assets, the amounts that it distributes to its stockholders, and the ownership of its stock. The Company may be required to make distributions to stockholders at disadvantageous times or when it does not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder the Company's ability to operate solely on the basis of maximizing profits.

*Complying with REIT requirements may limit Capstead's ability to hedge effectively.* The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from qualified hedges entered into prior to July 31, 2008,

**Table of Contents**

together with any other income not generated from qualified real estate assets, to no more than 25% of the Company's gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of its annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect its profitability. If the Company fails to satisfy the REIT gross income tests, unless its failure was due to reasonable cause and not due to willful neglect, the Company could lose its REIT status for federal income tax purposes.

*Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments.* To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of the Company's investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of the Company's assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 20% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

*Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders.* As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed taxable income. In addition, the Company will be subject to a 4% nondeductible excise tax if the actual amount that it pays out to its stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, the Company may generate taxable income greater than its net income for financial reporting purposes or its taxable income may be greater than the Company's cash flow available for distribution to stockholders. If the Company does not have other funds available in these situations, it could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable it to pay out enough of its taxable income to satisfy the distribution requirement and to avoid corporate income tax and/or the 4% excise tax in a particular year. These alternatives could increase the Company's costs or reduce its long-term investment capital.

*Capstead may be subject to adverse legislative or regulatory tax changes that could reduce the market price of the Company's securities.* At any time, the federal income tax laws governing REITs or the administrative interpretations of those laws may change. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect Capstead or its stockholders. For example, the Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum rate of tax applicable to individuals on dividend income from regular C corporations from 38.6% to 15.0%. This reduced substantially the so-called "double taxation" (that is, taxation at both the corporate and stockholder levels) that has generally applied to corporations that are not taxed as REITs. Generally, dividends from REITs will not qualify for the dividend tax reduction. As such, investors may view stocks of non-REIT dividend paying corporations as more attractive relative to shares of REITs than was the case previously. Capstead cannot predict any impact on the value of its securities from adverse legislative or regulatory tax changes such as the Jobs and Growth Tax Act of 2003.



**Table of Contents**

*An investment in Capstead's securities has various federal, state and local income tax risks that could affect the value of an investor's investment.* The Company strongly urges investors to consult their own tax advisor concerning the effects of federal, state and local income tax law on an investment in the Company's securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

***Risk Factors Related to Capstead's Corporate Structure***

*There are no assurances of Capstead's ability to pay dividends in the future.* Capstead intends to continue paying quarterly dividends and to make distributions to its stockholders in amounts such that all or substantially all of the Company's taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable the Company to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, the Company's ability to pay dividends may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of the Company's board of directors and will depend upon its earnings, its financial condition, maintenance of its REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of the Company's ability to pay dividends in the future. In addition, some of the Company's distributions may include a return of capital.

*Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations.* The Investment Company Act of 1940 exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the Investment Company Act of 1940. If the Company were to be regulated as an investment company, its ability to use leverage would be substantially reduced and it would be unable to conduct business as described in this filing.

The Securities and Exchange Commission, or SEC, staff's position generally requires Capstead to maintain at least 55% of its assets directly in qualifying real estate interests to be able to be exempted from regulation as an investment company. To constitute a qualifying real estate interest under this 55% requirement, a real estate interest must meet various criteria. In satisfying this 55% requirement, the Company may treat mortgage securities issued with respect to an underlying pool to which it holds all issued certificates as qualifying real estate interests. Mortgage securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as securities separate from the underlying mortgage loans and, thus, may not qualify for purposes of the 55% requirement. If the SEC or its staff adopts a contrary interpretation of its current treatment, the Company could be required to sell a substantial amount of its securities or other non-qualified assets under potentially adverse market conditions.

*Pursuant to Capstead's charter, its board of directors has the ability to limit ownership of the Company's capital stock, to the extent necessary to preserve its REIT qualification.* For the purpose of preserving Capstead's REIT qualification, its charter gives the board the ability to repurchase outstanding shares of the Company's capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of the Company's outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

**Table of Contents**

*Because provisions contained in Maryland law and Capstead's charter may have an anti-takeover effect, investors may be prevented from receiving a control premium for their shares.* Provisions contained in Capstead's charter and Maryland general corporation law may have effects that delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a control premium for their shares. For example, these provisions may defer or prevent tender offers for the Company's common stock or purchases of large blocks of the Company's common stock, thereby limiting the opportunities for its stockholders to receive a premium for their common stock over then-prevailing market prices. These provisions include the following:

*Repurchase Rights:* The repurchase rights granted to Capstead's board in its charter limits related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize the Company's REIT status.

*Classification of preferred stock:* Capstead's charter authorizes the board to issue preferred stock in one or more classes and to establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval. The issuance of preferred stock could have the effect of delaying or preventing someone from taking control of the Company, even if a change in control were in its stockholders' best interests.

Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of a Maryland corporation are not required to act in takeover situations under the same standards as apply in Delaware and certain other corporate jurisdictions.

*Capstead may change its policies without stockholder approval.* Capstead's board and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company's stockholders. Policy changes could adversely affect the Company's financial condition, results of operations, the market price of its common stock and/or preferred stock or the Company's ability to pay dividends or distributions.

**CRITICAL ACCOUNTING POLICIES**

Management's discussion and analysis of financial condition and results of operations is based upon Capstead's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that can affect the reported amounts of assets, liabilities (including contingencies), revenues and expenses, as well as related disclosures. These estimates are based on available internal and market information and appropriate valuation methodologies believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the expected useful lives and carrying values of assets and liabilities which can materially affect the determination of net income and book value per common share. Actual results may differ from these estimates under different assumptions or conditions.

**Table of Contents**

Management believes the following are critical accounting policies in the preparation of Capstead's consolidated financial statements that involve the use of estimates requiring considerable judgment:

*Amortization of Investment Premiums on Financial Assets* Investment premiums on financial assets are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. For most of Capstead's financial assets, estimates and judgments related to future levels of mortgage prepayments are critical to this determination. Mortgage prepayment expectations can vary considerably from period to period based on current and projected changes in interest rates and other factors such as portfolio composition. Management estimates mortgage prepayments based on past experiences with specific investments within the portfolio, and current market expectations for changes in interest rates and the residential mortgage lending environment. Should actual runoff rates differ materially from these estimates, investment premiums would be expensed at a different pace.

*Fair Value and Impairment Accounting for Financial Assets* Most of Capstead's investments are financial assets held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in *Stockholders' equity* as a component of *Accumulated other comprehensive income (loss)*. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions. Considerable judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 9 to the accompanying consolidated financial statements for discussion of how Capstead values its financial assets. Generally, gains or losses are recognized in earnings only if sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of *Other revenue (expense)* if (a) the decline was credit-related or (b) it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary impairment of a mortgage security because of other factors would be recognized in *Accumulated other comprehensive income (loss)* and amortized to earnings as a yield adjustment.

Considerable judgment is also required in determining whether an impairment charge should be recognized on an investment in an unsecuritized loan. The amount of any such impairment, regardless of whether it arose due to credit issues or other factors, would be recognized in earnings as a component of *Other revenue (expense)*. The amount of such charge would be determined by estimating expected future cash flows discounted at market rates.

*Derivatives Accounting* The Company uses Derivatives from time to time for risk management purposes. When held, Derivatives are recorded as assets or liabilities and carried at fair value. The accounting for changes in fair value of each Derivative held depends on whether it has been designated as an accounting hedge, as well as the type of hedging relationship identified. To qualify as cash flow hedges for accounting purposes, at the inception of the hedge relationship the Company must anticipate and document that the hedge relationship will be highly effective and monitor ongoing effectiveness on at least a quarterly basis. As long as the hedge relationship remains effective, the effective portion of changes in fair value of the Derivative are recorded in *Accumulated other comprehensive income (loss)* and the ineffective portion is recorded in earnings as a component of *Interest expense*. Changes in fair value of Derivatives not held as accounting hedges, or for which the hedge relationship is deemed to no longer be highly effective and as a result hedge accounting is terminated, are recorded in earnings as a component of *Other revenue (expense)*.

**Table of Contents**

Late in 2007 the Company began using interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of its current and anticipated future 30- and 90-day borrowings. Variable-rate payments to be received on the swap agreements and any measured hedge ineffectiveness are recorded in interest expense as an offset to interest owed on the hedged borrowings that reset to market rates generally on a monthly basis while fixed rate swap payments to be made are also recorded in interest expense resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTE 6 to the accompanying consolidated financial statements and Financial Conditions Residential Mortgage Investments for additional information regarding the Company's use of Derivatives and its related risk management policies.

**FORWARD LOOKING STATEMENTS**

This document contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that inherently involve risks and uncertainties. Capstead's actual results and liquidity can differ materially from those anticipated in these forward-looking statements because of changes in the level and composition of the Company's investments and other factors. These factors may include, but are not limited to, changes in general economic conditions, the availability of suitable qualifying investments from both an investment return and regulatory perspective, the availability of new investment capital, the availability of financing at reasonable levels and terms to support investing on a leveraged basis, fluctuations in interest rates and levels of mortgage prepayments, deterioration in credit quality and ratings, the effectiveness of risk management strategies, the impact of differing levels of leverage employed, liquidity of secondary markets and credit markets, increases in costs and other general competitive factors. In addition to the above considerations, actual results and liquidity related to investments in loans secured by commercial real estate are affected by borrower performance under operating and/or development plans, changes in general as well as local economic conditions and real estate markets, increases in competition and inflationary pressures, changes in the tax and regulatory environment including zoning and environmental laws, uninsured losses or losses in excess of insurance limits and the availability of adequate insurance coverage at reasonable costs, among other factors.

108

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS**

The information required by this Item is incorporated by reference to the information included in Item 2.

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

**ITEM 4. CONTROLS AND PROCEDURES**

As of September 30, 2009, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2009. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to September 30, 2009.

-40-

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**Table of Contents**

**PART II. OTHER INFORMATION**

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits: The following Exhibits are presented herewith:

Exhibit 12 Computation of Ratio of Income from Continuing Operations (before fixed charges) to Combined Fixed Charges and Preferred Stock Dividends.

Exhibit 31.1 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002

Exhibit 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K:

Current Report on Form 8-K dated July 14, 2009 furnishing certain compensation matters for the Company's named executive officers effective July 1, 2009.

Current Report on Form 8-K dated July 29, 2009 furnishing the press release announcing second quarter 2009 results.

Current Report on Form 8-K dated July 30, 2009 to file investor presentation materials pertaining to the Company's second quarter earnings conference call.

Current Report on Form 8-K dated August 17, 2009 to file a second quarter 2009 investor fact sheet.

Current Report on Form 8-K dated September 21, 2009 to file a presentation to the investment community.

**Table of Contents**

**SIGNATURES**

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

**CAPSTEAD MORTGAGE  
CORPORATION  
Registrant**

Date: November 4, 2009

By: /s/ ANDREW F. JACOBS  
Andrew F. Jacobs  
President and Chief Executive Officer

Date: November 4, 2009

By: /s/ PHILLIP A. REINSCH  
Phillip A. Reinsch  
Executive Vice President and  
Chief Financial Officer

-42-