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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
FORM 10-K

☒ **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the fiscal year ended December 31, 2013**  
**or**

☐ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**Commission File Number: 1-9819**

**DYNEX CAPITAL, INC.**  
**(Exact name of registrant as specified in its charter)**

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

**52-1549373**  
(I.R.S. Employer  
Identification No.)

**4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia**  
(Address of principal executive offices)

**23060-9245**  
(Zip Code)

**(804) 217-5800**  
(Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, \$.01 par value	New York Stock Exchange
8.50% Series A Cumulative Redeemable Preferred Stock, par value \$0.01 per share	New York Stock Exchange
7.625% Series B Cumulative Redeemable Preferred Stock, par value \$0.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.  
Yes ☐ No ☒

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).

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Yes      x      No      o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes      o      No      x

As of June 30, 2013, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$518,414,092 based on the closing sales price on the New York Stock Exchange of \$10.19.

On February 27, 2014, the registrant had 54,731,135 shares outstanding of common stock, \$0.01 par value, which is the registrant's only class of common stock.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement for the registrant's 2014 annual meeting of shareholders, expected to be filed pursuant to Regulation 14A within 120 days from December 31, 2013, are incorporated by reference into Part III.

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**DYNEX CAPITAL, INC.**  
**FORM 10-K**  
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*CAUTIONARY STATEMENT – This Annual Report on Form 10-K may contain “forward-looking” statements within the meaning of Section 27A of the Securities Act of 1933, as amended (or “1933 Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (or “Exchange Act”). We caution that any such forward-looking statements made by us are not guarantees of future performance, and actual results may differ materially from those expressed or implied in such forward-looking statements. Some of the factors that could cause actual results to differ materially from estimates expressed or implied in our forward-looking statements are set forth in this Annual Report on Form 10-K for the year ended December 31, 2013. See Item 1A. “Risk Factors” as well as “Forward-Looking Statements” set forth in Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Annual Report on Form 10-K.*

*In this Annual Report on Form 10-K, we refer to Dynex Capital, Inc. and its subsidiaries as “the Company,” “we,” “us,” or “our,” unless we specifically state otherwise or the context indicates otherwise.*

## **PART I.**

### **ITEM 1. BUSINESS**

#### **COMPANY OVERVIEW**

We are an internally managed mortgage real estate investment trust, or mortgage REIT, which invests in mortgage assets on a leveraged basis. Our common stock is traded on the New York Stock Exchange (“NYSE”) under the symbol “DX”. We also have two series of Preferred Stock outstanding, our 8.50% Series A Cumulative Redeemable Preferred Stock (the “Series A Preferred Stock”) which is traded on the NYSE under the symbol “DXPRA”, and our 7.625% Series B Cumulative Redeemable Preferred Stock (the “Series B Preferred Stock”) which is traded on the NYSE under the symbol “DXPRB”. Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders through regular quarterly dividends and through capital appreciation.

We were formed in 1987 and commenced operations in 1988. Beginning with our inception through 2000, our operations largely consisted of originating and securitizing various types of loans, principally single-family and commercial mortgage loans and manufactured housing loans. Since 2000, we have been investing in Agency and non-Agency mortgage-backed securities (“MBS”), and we are no longer originating or securitizing mortgage loans. MBS consist of residential MBS (“RMBS”) and commercial MBS (“CMBS”), including CMBS interest-only (“IO”) securities. Agency MBS have a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity (“GSE”) such as Fannie Mae and Freddie Mac. Non-Agency MBS have no such guaranty of payment.

Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We invest our capital pursuant to our Operating Policies as approved by our Board of Directors which include an Investment Policy and Investment Risk Policy as further discussed below. Our investment policy permits investments in any type of Agency MBS and investment grade non-Agency MBS, legacy securitized mortgage loans, and legacy whole loans.

Since 2008 we have invested primarily in higher credit quality and shorter duration investments. When we have purchased longer duration investments, we have generally reduced the duration risk on these investments through our hedging strategy as discussed further below.

**RMBS.** Our Agency RMBS investments include MBS collateralized by adjustable-rate mortgage loans (“ARMS”), which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index, and hybrid adjustable-rate mortgage loans (“hybrid ARMs”), which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and then adjust their interest rate at least annually to an increment over a specified interest rate index as further discussed below. Agency ARMs also include hybrid Agency ARMs that are past their fixed-rate periods or within twelve months of their initial reset period. We may also invest in fixed-rate Agency RMBS from time to time. Additionally, we invest in non-Agency RMBS which generally resemble similar types of Agency ARMs, but lack a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity.



Interest rates on loans collateralizing Agency and non-Agency ARMs are based on specific index rates, such as the London Interbank Offered Rate, or LIBOR, the one-year constant maturity treasury rate, or CMT, the Federal Reserve U.S. 12-month cumulative average one-year CMT, or MTA, or the 11th District Cost of Funds Index, or COFI. These loans will typically have interim and lifetime caps on interest rate adjustments, or interest rate caps, limiting the amount that the rates on these loans may reset in any given period.

**CMBS.** Our Agency and non-Agency CMBS are collateralized by first mortgage loans and are comprised of substantially fixed-rate securities. The majority of the loans collateralizing our CMBS are secured by multifamily properties. Typically these loans have some form of prepayment protection provisions (such as prepayment lock-out) or prepayment compensation provisions (such as yield maintenance or prepayment penalty). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay.

**CMBS IO.** A portion of our Agency and non-Agency CMBS also include IO securities which represent the right to receive excess interest payments (but not principal cash flows) based on the underlying unpaid principal balance of the underlying pool of mortgage loans. As these securities have no principal associated with them, the interest payments received are based on the unpaid principal balance (often referred to as the notional amount) of the underlying pool of mortgage loans. CMBS IO securities generally have prepayment protection in the form of lock-outs, prepayment penalties, or yield maintenance associated with the underlying loans similar to CMBS described above.

### ***Operating Policies and Restrictions***

Our Operating Policies set forth investment and risk limitations as they relate to the Company's investment activities and are reviewed annually by the Board. We also manage our operations and investments to comply with various REIT limitations (as discussed further below in "Federal Income Tax Considerations") and to avoid qualifying as an investment company as such term is defined in the 1940 Act or as a commodity pool operator under the Commodity Exchange Act and the rules and regulations promulgated thereunder.

The Operating Policies target an allocation of 40% of our assets to non-Agency MBS and limit our purchases of non-investment grade and non-rated MBS to no more than 10% of our total capital. Investment grade MBS are MBS which are rated 'BBB' or higher by at least one nationally recognized statistical ratings organization. We will conduct our own independent evaluation of the credit risk on any non-Agency MBS, such that we do not rely solely on the security's credit rating. In general, our limited purchases of non-rated MBS in recent years have been shorter duration securities which we believe to have minimal credit risk as opposed to longer duration MBS that may have more significant credit risk.

The Operating Policies also limit the overall leverage of the Company to seven times our shareholders' equity capital (consisting of common and preferred equity), up to ten times our equity capital invested in Agency MBS, and six times our equity capital invested in non-Agency MBS. In addition, among other things, there are limitations on interest rate and convexity risk, and our earnings at risk and our shareholders' equity at risk due to changes in interest rates, prepayment rates, investment prices and spreads. The Operating Policies require us to perform a variety of stress tests on the investment portfolio value and liquidity from adverse market conditions.

### ***Investment Philosophy and Strategy***

Our investment philosophy is based on a macroeconomic, top-down approach and forms the foundation of our investment strategy. We focus on the expected risk-adjusted outcome of any investment which, given our use of leverage, must include the terms of financing and the expected liquidity of the investment. Key points of our investment philosophy and strategy include the following:

- understanding macroeconomic conditions including the current state of the U.S. and global economies, the regulatory environment, competition for assets, and the availability of financing;
- sector analysis including understanding absolute returns, relative returns and risk-adjusted returns;
- security and financing analysis including sensitivity analysis on credit, interest rate volatility, and market value risk; and
- managing performance and portfolio risks, including interest rate, credit, prepayment, and liquidity risks.

In executing our investment strategy, we seek to balance the various risks of owning mortgage assets with the earnings opportunity on the investment. We believe our strategy of investing in Agency and non-Agency mortgage assets provides superior diversification of these risks across our investment portfolio and therefore provides ample opportunities to generate attractive risk-adjusted returns while protecting our shareholders' capital.

The performance of our investment portfolio will depend on many factors including interest rates, trends of interest rates, the steepness of interest rate curves, prepayment rates on our investments, competition for investments, economic conditions and their impact on the credit performance of our investments, and actions taken by the U.S. government, including the U.S. Federal Reserve and the United States Department of the Treasury (the "Treasury"). In addition, our business model may be impacted by other factors such as the state of the overall credit markets, which could impact the availability and costs of financing. See "Factors that Affect Our Results of Operations and Financial Condition" below and "Risk Factors-Risks Related to Our Business" in Item 1A of Part I of this Annual Report on Form 10-K for further discussion.

### ***Financing and Hedging Strategy***

We finance our investments primarily through the use of recourse repurchase agreements, and to a lesser extent, non-recourse collateralized financing.

*Repurchase Agreements.* The majority of our repurchase agreement financing is uncommitted short-term financing in which we pledge our MBS as collateral to secure loans made by the repurchase agreement counterparty. These repurchase agreements generally have terms of 30-180 days, though in some instances longer terms may be available, and carry a rate of interest which is usually based on a spread to one-month LIBOR and fixed for the term of the borrowing. Borrowings under these repurchase agreements are renewable at the discretion of our lenders and do not contain guaranteed roll-over terms. We also have available to us a committed repurchase agreement financing facility with an aggregate borrowing capacity of \$250.0 million which currently has a termination date in August 2015; financing provided under this facility is secured by Agency and non-Agency CMBS IO. The amount borrowed under a repurchase agreement is limited by the lender to a percentage of the estimated market value of the pledged collateral, which is generally up to 95% of the estimated market value for Agency MBS and up to 90% for higher credit quality non-Agency MBS. The difference between the market value of the pledged MBS collateral and the amount of the repurchase agreement is the amount of equity we have in the position and is intended to provide the lender some protection against fluctuations of value in the collateral and/or the failure by us to repay the borrowing at maturity.

If the fair value of the MBS pledged as collateral declines, lenders may require that we pledge additional assets to collateralize the outstanding repurchase agreement borrowings by initiating a margin call. The fair value in collateral pledged fluctuates primarily as a result of principal payments and changes in market interest rates and spreads, prevailing market yields, actual or anticipated prepayment speeds and other market conditions. Lenders may also initiate margin calls during periods of market stress as a result of actual or expected volatility in asset prices. There is no minimum amount of collateral value decline required before the lender could initiate a margin call. If we fail to meet any margin call, our lenders have the right to terminate the repurchase agreement and sell the collateral pledged. We attempt to maintain cash and other liquid securities in sufficient amounts to manage our exposure to margin calls by lenders.

Repurchase agreement financing is provided principally by major financial institutions and broker-dealers. A significant source of liquidity for the repurchase agreement market is money market funds which provide collateral-based lending to the financial institutions and broker-dealer community that, in turn, is provided to the repurchase agreement market. In order to reduce our exposure to counterparty-related risk, we generally seek to diversify our exposure by entering into repurchase agreements with multiple lenders.

For further discussion of repurchase agreement financing, please refer to "Liquidity and Capital Resources" in Item 7 of Part II of this Annual Report on Form 10-K.

*Hedges and Derivative Instruments.* We enter into a variety of derivative instruments to mitigate our exposure to market events outside of our control which could negatively impact our earnings, cash flow or book value. Our hedging activities attempt primarily to reduce our exposure to adverse effects from changes in interest rates. For example, given the nature of our investing and financing activities, in a period of rising interest rates our earnings and cash flow may be negatively impacted by our borrowing costs increasing faster than income from our assets, and our book value may decline as a result of declining market values of our

MBS. We enter into derivative instruments in an attempt to partially or fully mitigate our exposure to these changes in interest rates. We typically utilize interest rate swap agreements and Eurodollar futures to hedge interest rate risk, but may also utilize interest rate cap or floor agreements, put and call options on securities or securities underlying futures contracts, forward rate agreements, or swaptions. We do not attempt to hedge the risk related to changes in market credit spreads (often referred to as basis risk) as we do not believe an efficient and cost-effective hedging strategy exists for this risk.

As of December 31, 2013, our derivative instruments consisted of interest rate swap agreements and Eurodollar contracts. In conducting our hedging activities, we intend to comply with REIT and tax limitations on our hedging instruments which could limit our activities and the instruments that we may use. We also intend to enter into derivative contracts only with the counterparties that we believe have a strong credit rating to help mitigate the risk of counterparty default or insolvency.

We record our derivative and hedge transactions in accordance with GAAP as per the guidance in Accounting Standards Codification Topic 815 "Derivatives and Hedging". Prior to June 30, 2013, we elected to use cash flow hedge accounting under ASC Topic 815 which states that the effective portion of the hedge relationship on an instrument designated as a cash flow hedge is reported in the current period's other comprehensive income ("OCI") and is later reclassified to the consolidated statement of net income as "interest expense" in the same period during which the hedged transaction affects earnings; while the ineffective portion is immediately reported in the current period's consolidated statement of net income. Since June 30, 2013, we have elected to discontinue cash flow hedge accounting, which means all activity related to our derivative instruments is now recorded in the current period's consolidated statement of net income as a portion of "loss on derivative instruments, net". As a result of this mark-to-market accounting treatment, our results of operations are likely to fluctuate due to changes in the fair value of derivative instruments to a greater extent than if we were to have continued using cash flow hedge accounting.

*Non-Recourse Collateralized Financing.* In the past we have utilized securitization financing to finance securitized mortgage loans and certain MBS. Securitization financing is term financing collateralized by securitized mortgage loans and is non-recourse to us. Each series of securitization financing may consist of various classes of bonds at either fixed or variable rates of interest and having varying repayment terms. Payments received on securitized mortgage loans and reinvestment income earned thereon is used to make payments on the securitization financing bonds. Management does not currently have plans to enter into any additional securitization financing arrangements.

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

The performance of our investment portfolio, including the amount of net interest income we earn and fluctuations in investment values, will depend on multiple factors, many of which are beyond our control. These factors include, but are not limited to, the absolute level of interest rates, trends of interest rates, the relative steepness of interest rate curves, prepayment rates on our investments, competition for investments, economic conditions and their impact on the credit performance of our investments (including multifamily, residential and commercial mortgage markets), and market required yields as reflected by market credit spreads. In addition, the performance of our investment portfolio, the cost and availability of financing and the availability of investments at acceptable return levels could be influenced by actions and policy measures of the U.S. government including the Federal Housing Finance Administration, the U. S. Department of the Treasury (the "Treasury"), and the U.S. Federal Reserve.

Our business model may also be impacted by other factors such as the availability and cost of financing and the state of the overall credit markets. Reductions in the availability of financing for our investments could significantly impact our business and force us to sell assets that we otherwise would not sell, potentially at losses or at amounts below their true fair value. Other factors also impacting our business include changes in regulatory requirements, including requirements to qualify for registration under the Investment Company Act of 1940 and REIT requirements.

Investing in mortgage-related securities while using leverage to increase our return on shareholders' capital subjects us to a number of risks including interest rate risk, prepayment and reinvestment risk, credit risk, market value risk and liquidity risk, which are discussed in Part I, Item 1A, "Risk Factors" as well as "Liquidity and Capital Resources" within Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Part II, Item 7A, "Quantitative and Qualitative Disclosures about Market Risk" of this Annual Report on Form 10-K. Please see these Items for a detailed discussion of these risks and the potential impact on our results of operations and financial condition.

## INDUSTRY OVERVIEW

The public mortgage REIT industry has grown significantly since the beginning of 2008 and includes approximately 30 companies with a total market capitalization of \$62.1 billion as of December 31, 2013. Mortgage REITs provide liquidity to the U.S. real estate markets through the purchase of RMBS and CMBS and through the origination or purchase of mortgage loans. The business models of mortgage REITs range from investing only in Agency MBS to investing substantially in non-investment grade MBS and loans. Each mortgage REIT will assume risks in its investment strategy. Whereas we invest in shorter-duration and higher quality MBS in order to mitigate interest rate risk and credit risk, other mortgage REITs may be willing to accept more of these risks than we are.

Given the need for private capital to replace the capital currently supporting mortgage finance (from governmental and quasi-governmental public entities such as Fannie Mae, Freddie Mac, GNMA and the Federal Reserve), we believe that mortgage REITs will continue to increase in importance to the U.S. housing and mortgage finance industries. In addition, the uncertainty around regulation of financial institutions under the Dodd-Frank Act, minimum capital standards that will be implemented under the Basel III Accord, increased risk-weightings for certain types of mortgage loans held by depository institutions, increased regulatory requirements related to origination of certain types of residential mortgage loans, and other potential regulatory changes, may further impact capital formation in the U.S. mortgage market which could favor mortgage REITs. There are potential consequences to increased regulation however, including increasing borrowing costs or reduced availability of repurchase agreement financing and the need to post more capital to leverage our investments and/or enter into derivative instruments.

## COMPETITION

The financial services industry in which we compete is a highly competitive market. In purchasing investments and obtaining financing, we compete with other mortgage REITs, broker dealers and investment banking firms, mutual funds, banks, hedge funds, mortgage bankers, insurance companies, governmental bodies, and other entities, many of which have greater financial resources and a lower cost of capital than we do. Increased competition in the market may reduce the available supply of investments and may drive prices of investments to unacceptable levels which would negatively impact our ability to earn an acceptable amount of income from these investments. Competition can also reduce the availability of borrowing capacity at our repurchase agreement counterparties as such capacity is not unlimited, and many of our repurchase agreement counterparties limit the amount of financing they offer to the mortgage REIT industry.

## FEDERAL INCOME TAX CONSIDERATIONS

As a REIT, we are required to abide by certain requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). To retain our REIT status, the REIT rules generally require that we invest primarily in real estate-related assets, that our activities be passive rather than active and that we distribute annually to our shareholders substantially all of our taxable income, after certain deductions, including deductions for our tax net operating loss ("NOL") carryforward. We could be subject to income tax if we failed to satisfy those requirements. We use the calendar year for both tax and financial reporting purposes.

We estimate that our NOL carryforward was approximately \$142.3 million as of December 31, 2013, subject to the completion of our 2013 federal income tax return. The NOL expires substantially beginning in 2020. We can utilize our NOL carryforward to offset our taxable earnings after taking the REIT distribution requirements into account. As a result of our public offering of common stock in February 2012, we incurred an "ownership change" as such term is defined in Section 382 of the Code. Based on management's analysis and expert third-party advice, which necessarily includes certain assumptions regarding the characterization under Section 382 of our use of capital raised by us, we determined that the ownership change under Section 382 limits our ability to use our NOL carryforward to a maximum amount of \$13.5 million per year. This annual limitation may effectively limit the cumulative amount of pre-ownership change losses, including certain recognized built-in losses, that we may utilize.

There may be differences between taxable income and income computed in accordance with U.S. generally accepted accounting principles ("GAAP"). These differences primarily arise from timing differences in the recognition of revenue and expense for tax and GAAP purposes.

Failure to satisfy certain Code requirements could cause us to lose our status as a REIT. If we failed to qualify as a REIT for any taxable year, we may be subject to federal income tax (including any applicable alternative minimum tax) at regular corporate rates and would not receive deductions for dividends paid to shareholders. We could, however, utilize our NOL carryforward to offset any taxable income. In addition, given the size of our NOL carryforward, we could pursue a business plan in the future in which we would voluntarily forego our REIT status. If we lost or otherwise surrendered our status as a REIT, we could not elect REIT status again for five years. Several of our investments in securitized mortgage loans have ownership restrictions limiting their ownership to REITs. Therefore, if we chose to forego our REIT status, we would have to sell these investments or otherwise provide for REIT ownership of these investments. In addition, many of our repurchase agreement lenders and interest rate swap counterparties require us to maintain our REIT status. If we were to lose our REIT status, these lenders would have the right to terminate any repurchase agreement borrowings and interest rate swaps outstanding at that time.

We also have a taxable REIT subsidiary ("TRS"), which had an NOL carryforward of approximately \$3.5 million as of December 31, 2013, subject to the completion of our 2013 federal income tax return. The TRS has limited operations, and, accordingly, we have established a full valuation allowance for the related deferred tax asset.

#### **Qualification as a REIT**

Qualification as a REIT requires that we satisfy a variety of tests relating to our income, assets, distributions and ownership. The significant tests are summarized below.

*Sources of Income.* To continue qualifying as a REIT, we must satisfy two distinct tests with respect to the sources of our income: the "75% income test" and the "95% income test." The 75% income test requires that we derive at least 75% of our gross income (excluding gross income from prohibited transactions) from certain real estate-related sources. In order to satisfy the 95% income test, 95% of our gross income for the taxable year must consist of either income that qualifies under the 75% income test or certain other types of passive income.

If we fail to meet either the 75% income test or the 95% income test, or both, in a taxable year, we might nonetheless continue to qualify as a REIT, if our failure was due to reasonable cause and not willful neglect and the nature and amounts of our items of gross income were properly disclosed to the Internal Revenue Service. However, in such a case we would be required to pay a tax equal to 100% of any excess non-qualifying income.

*Nature and Diversification of Assets.* At the end of each calendar quarter, we must meet multiple asset tests. Under the "75% asset test", at least 75% of the value of our total assets must represent cash or cash items (including receivables), government securities or real estate assets. Under the "10% asset test," we may not own more than 10% of the outstanding voting power or value of securities of any single non-governmental issuer, provided such securities do not qualify under the 75% asset test or relate to taxable REIT subsidiaries. Under the "5% asset test," ownership of any stocks or securities that do not qualify under the 75% asset test must be limited, in respect of any single non-governmental issuer, to an amount not greater than 5% of the value of our total assets (excluding ownership of any taxable REIT subsidiaries).

If we inadvertently fail to satisfy one or more of the asset tests at the end of a calendar quarter, such failure would not cause us to lose our REIT status, provided that (i) we satisfied all of the asset tests at the close of the preceding calendar quarter and (ii) the discrepancy between the values of our assets and the standards imposed by the asset tests either did not exist immediately after the acquisition of any particular asset or was not wholly or partially caused by such an acquisition. If the condition described in clause (ii) of the preceding sentence was not satisfied, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

*Ownership.* In order to maintain our REIT status, we must not be deemed to be closely held and must have more than 100 shareholders. The closely held prohibition requires that not more than 50% of the value of our outstanding shares be owned by five or fewer persons at any time during the last half of our taxable year. The "more than 100 shareholders" rule requires that we have at least 100 shareholders for 335 days of a twelve-month taxable year. In the event that we failed to satisfy the ownership requirements we would be subject to fines and be required to take curative action to meet the ownership requirements in order to maintain our REIT status.

## EMPLOYEES

As of December 31, 2013, we have 18 employees and one corporate office in Glen Allen, Virginia. None of our employees are covered by any collective bargaining agreements, and we are not aware of any union organizing activity relating to our employees.

### Executive Officers of the Registrant

<u>Name (Age)</u>	<u>Current Title</u>	<u>Business Experience</u>
Thomas B. Akin (61)	Executive Chairman and Director	Executive Chairman effective January 1, 2014; Chief Executive Officer between 2008 and 2013; Chairman of the Board since 2003; managing general partner of Talkot Capital, LLC.
Byron L. Boston (55)	Chief Executive Officer, President, Co-Chief Investment Officer, and Director	Chief Executive Officer and Co-Chief Investment Officer effective January 1, 2014; President and Director since 2012; Chief Investment Officer since 2008.
Stephen J. Benedetti (51)	Executive Vice President, Chief Operating Officer, and Chief Financial Officer	Executive Vice President and Chief Operating Officer since 2005; Executive Vice President and Chief Financial Officer from 2001 to 2005 and beginning again in 2008.
Smriti L. Popenoe (44)	Executive Vice President and Co-Chief Investment Officer	Executive Vice President and Co-Chief Investment Officer effective January 1, 2014; Chief Risk Officer of PHH Corporation between 2010 and 2013; Senior Vice President, Balance Sheet Management, of Wachovia Bank, from 2006 to 2009.

## AVAILABLE INFORMATION

We are subject to the reporting requirements of the Exchange Act and its rules and regulations. The Exchange Act requires us to file reports, proxy statements, and other information with the SEC. Copies of these reports, proxy statements, and other information can be read and copied at:

SEC Public Reference Room  
100 F Street, N.E.  
Washington, D.C. 20549

Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy statements, and other information regarding issuers that file electronically with the SEC. These materials may be obtained electronically by accessing the SEC's home page at [www.sec.gov](http://www.sec.gov).

Our website can be found at [www.dynexcapital.com](http://www.dynexcapital.com). Our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, are made available free of charge through our website as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC.

We have adopted a Code of Business Conduct and Ethics ("Code of Conduct") that applies to all of our employees, officers and directors. Our Code of Conduct is also available free of charge on our website, along with our Audit Committee Charter, our Nominating and Corporate Governance Committee Charter, and our Compensation Committee Charter. We will post on our website amendments to the Code of Conduct or waivers from its provisions, if any, which are applicable to any of our directors or executive officers in accordance with SEC or NYSE requirements.

## ITEM 1A. RISK FACTORS

Our business is subject to various risks, including those described below. Our business, operating results, and financial condition could be materially and adversely affected by any of these risks. Please note that additional risks not presently known to us or that we currently deem immaterial could also impair our business, operating results, and financial condition.

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### Risks Related to Our Business

*The Federal Reserve continues to use monetary policy including a 0%-0.25% targeted federal funds rate and its asset purchase operations being conducted by the Federal Reserve Bank of New York ("FRBNY") to support economic growth in the U.S. If the Federal Reserve begins reducing liquidity to the markets by tightening monetary policy, or if the FRBNY were to sell securities it holds or even announce that it intends to sell these securities, market interest rates and credit spreads are likely to increase dramatically which could negatively impact our reported results, our operations, our liquidity and our book value.*

The Federal Open Market Committee ("FOMC") of the Federal Reserve has maintained its targeted federal funds rate at the historically low range of between 0% and 0.25% since 2008. The FOMC has also sought to provide additional policy monetary stimulus by expanding the holdings of longer term securities in its portfolio, including large-scale purchases of Treasury securities and fixed-rate Agency RMBS (which the market has referred to as quantitative easing, or "QE"). The QE program has been executed at various times since 2008. The purchases are intended to lower longer-term interest rates in general and mortgage rates in particular, and contribute to an overall easing of monetary conditions. The Federal Reserve and FOMC have implemented monetary policy through open market operations conducted by the FRBNY.

As of January 8, 2014, the FRBNY held \$3.7 trillion of securities, of which \$1.5 trillion were Agency MBS and \$2.2 trillion were U.S. Treasury securities, most of which has been accumulated pursuant to the QE program. Beginning in December 2013, the FOMC announced its intention to reduce monthly purchases under the QE program from \$85 billion to \$75 billion given the improved outlook for the US economy, and the FOMC and FRBNY are expected to continue to reduce such purchases in future months. The FOMC had previously mentioned reducing, or "tapering" its purchases in May 2013. Over the ensuing 2 months, two-year and ten-year treasury rates increased 0.18% and 1.11%, respectively, and ended up increasing 0.19% and 1.40%, respectively, by year end.

The actions of the Federal Reserve in the context of modern U.S. financial history are unprecedented. The potential market volatility from the Federal Reserve's future withdrawal of support via these asset purchases, or a future increase in the targeted federal funds rate may be extreme. Once the Federal Reserve announces a higher targeted range or if markets determine that the Federal Reserve is likely to announce a higher targeted range, our borrowing costs are likely to increase which will negatively impact our results of operations and could impact our financial condition and book value. Further, the timing and method of the ultimate disposition of securities purchased by the Federal Reserve (including the FRBNY) is not known, and significant price volatility could occur following large asset sales (or anticipation thereof) by the Federal Reserve. In such a case, it is likely that prices could decline which would cause a decline in our book value and also could result in margin calls by our lenders with respect to Agency MBS that are pledged as collateral for repurchase agreements. If declines in prices are substantial, this could force us to sell assets at a loss or at an otherwise inopportune time in order to meet margin calls or repay lenders.

*Our business model depends on our ability to access credit to finance our investments. Our inability to access financing on reasonable terms could materially adversely affect our operations, financial condition and business which may, in turn, negatively affect the market price of our stock.*

We depend heavily upon the availability of adequate funding for our investment activities, with such funding primarily consisting of repurchase agreement financing. Our access to financing depends upon a number of factors, over which we have little or no control, including:

- general market and economic conditions;
- the actual or perceived financial condition of credit market participants including banks, broker-dealers, hedge funds, and money-market funds, among others;
- the impact of governmental policies and/or regulations on institutions with respect to activities in the credit markets;
- market perception of quality and liquidity of the type of assets in which we invest; and
- market perception of our financial strength.

Repurchase agreements are generally short-term commitments of capital. Disruptions or volatility in the credit and repurchase agreement markets can and do periodically occur and can result in diminished financing capacity for mortgage securities. These events can lead to adverse impacts on the values of mortgage securities. If a severe event were to occur, lenders may be unwilling or unable to provide financing for our investments or may be willing to provide financing only at much higher rates. This may impact our profitability by increasing our borrowing costs or by forcing us to sell assets. In an extreme case, this may also result in our inability to finance some or all of our securities which could force us to liquidate all or portions of our investment portfolio, potentially in an adverse market environment.

In addition, it is possible that the lenders that provide us with financing could experience changes in their ability or willingness to provide financing, independent of our performance or the value of our assets. Such changes could occur as a result of regulatory changes for our lenders, market conditions or their financial condition. If major market participants exit the financing markets or otherwise restrict their financing to us, it would increase the competition for available repurchase agreement financing, which could adversely affect the marketability and value of our securities and other financial assets in which we invest and could force us to sell assets potentially when asset prices are depressed. These actions would negatively impact our book value and our profitability.

The amount of financing we receive under our repurchase agreements will be directly related to the lenders' valuation of the assets that secure outstanding borrowings. Typically, repurchase agreements grant the respective lender the right to reevaluate the market value of the assets that secure outstanding borrowings at any time. If a lender determines that the value of the assets has decreased, it has the right to initiate a margin call. A margin call would require us to transfer additional assets to such lender or to repay a portion of the outstanding borrowings. Any such margin call could have a material adverse effect on our results of operations, financial condition, business, liquidity and ability to make distributions to shareholders, and could cause the value of our common stock to decline. We may be forced to sell assets at significantly depressed prices to meet margin calls and to maintain adequate liquidity, which could cause us to incur losses. Moreover, to the extent that we are forced to sell assets because of changes in market conditions, other market participants may face similar pressures, which could exacerbate a difficult market environment, further depress market values of our assets and result in significantly greater losses on our sale of such assets. In an extreme case of market duress, a market may not exist for certain of our assets at any price.

In addition, if repurchase agreement financing were not available or if it were not available on reasonable terms, we could implement a strategy of reducing our leverage by selling assets or not replacing MBS as they amortize and/or prepay, thereby decreasing the outstanding amount of our related borrowings. Such an action would likely reduce interest income, interest expense and net income, the extent of which would depend on the level of reduction in assets and liabilities as well as the sale prices for which the assets were sold.

***Repurchase agreements are generally uncommitted short-term financings and changes to terms of such financing may adversely affect our profitability.***

Repurchase agreements are generally uncommitted financings from lenders with an average term of ninety days or less. Since we rely heavily on borrowings under repurchase agreements to finance certain of our investments, our ability to achieve our investment and profitability objectives depends on our ability to borrow in sufficient amounts and on favorable terms and to renew or replace maturing borrowings on a continuous basis. If the terms on which we borrow change in a meaningful way, our profitability may be impacted which could reduce distributions to our shareholders.



***A decline in the market value of our assets may cause our book value to decline and/or may result in margin calls that could force us to sell assets under adverse market conditions.***

The market value of our assets is generally determined by the marketplace on a spread to the Treasury and or LIBOR swap interest rate curves. Interest rate fluctuations will cause the market values of our investments to fluctuate and, in particular, rising interest rates often cause the market values of our investments to decrease. The movement of the Treasury and LIBOR swap curves and changes in market spreads can result from a variety of factors, including but not limited Federal Reserve policy, market inflation expectations, market perceptions of risk, and changes in the liquidity of our investments. In periods of uncertainty or high volatility, market spreads may dramatically increase, causing rapid declines in the value of our assets. As most of our investments are considered available for sale under GAAP and are therefore carried at fair value in our financial statements, the decline in value would cause our shareholders' equity to correspondingly decline. In addition, because we utilize recourse collateralized financing such as repurchase agreements, a decline in the market value of our investments may limit our ability to borrow against these assets or result in our lenders initiating margin calls and requiring a pledge of additional collateral or cash. Posting additional collateral or cash to support our borrowings would reduce our liquidity and limit our ability to leverage our assets, which could adversely affect our business. As a result, we could be forced to sell some of our assets in order to maintain liquidity. Forced sales typically result in lower sales prices than do market sales made in the normal course of business. If our investments were liquidated at prices below the amortized cost basis of such investments, we would incur losses, which could result in a rapid deterioration of our financial condition.

***Our inability to meet certain covenants in our repurchase agreements and derivative instruments could adversely affect our financial condition, results of operations and cash flows.***

In connection with certain of our repurchase agreements and derivative instruments, we are required to maintain certain financial and financial covenants. The most restrictive requires that, on any date, we have (i) a minimum of \$30 million of liquidity; (ii) a minimum shareholders' equity of the sum of \$110 million and 90% of all net capital contributions after June 30, 2008; (iii) declines in shareholders' equity less than 25% in any quarter and 35% in any year; and (iv) a maximum debt-to-equity ratio of 7-to-1. In addition, virtually all of our repurchase agreements and derivative instruments require us to maintain our status as a REIT and to be exempted from the provisions of the 1940 Act. Compliance with these covenants depends on market factors and the strength of our business and operating results. Various risks, uncertainties and events beyond our control, including significant fluctuations in interest rates, could affect our ability to comply with these covenants. Failure to comply with these covenants could result in an event of default, termination of a repurchase agreement, acceleration of all amounts owing under the repurchase agreement, and generally gives the counterparty the right to exercise certain other remedies under the repurchase agreement, including the sale of the asset subject to repurchase at the time of default, unless we were able to negotiate a waiver in connection with any such default related to failure to comply with a covenant. Any such waiver could be conditioned on an amendment to the repurchase agreement and any related guaranty agreement on terms that may be unfavorable to us. If we are unable to negotiate a covenant waiver or replace or refinance our assets under a new repurchase facility on favorable terms or at all, our financial condition, results of operations and cash flows could be adversely affected. Further, certain of our repurchase agreements have cross-default, cross-acceleration or similar provisions, such that if we were to violate a covenant under one repurchase agreement, that violation could lead to defaults, accelerations or other adverse events under other repurchase agreements, as well.

***Non-Agency MBS have more price sensitivity than Agency MBS which can cause greater fluctuations in our book value. In addition, we finance our non-Agency MBS with a limited number of repurchase agreement lenders. A withdrawal by one or more of these lenders could force us to sell our non-Agency MBS at potentially distressed prices which could impact our profitability. It could also cause other lenders to withdraw financing for our Agency MBS.***

Non-Agency MBS historically have been more price sensitive than Agency MBS which limits the number of lenders willing to provide repurchase agreement financing for these securities. In a period of price volatility, we may be subject to margin calls which could adversely impact our liquidity. These margin calls could result from price changes in the non-Agency MBS or from higher margin requirements by the lender in order to provide additional collateral as a result of the price volatility. In addition, lenders may no longer offer financing of non-Agency MBS which could force us to sell some or all of these investments if we could not find replacement financing. In either instance we may be required to sell assets which could negatively impact our profitability. In an extreme situation, if we lost significant amounts of financing or if we received a significant amount of margin calls on our non-Agency MBS, other lenders may also seek to reduce their financing of our Agency MBS. In such a case we would likely have to sell additional investments to maintain our liquidity.

***The Federal Reserve and other U.S. regulators, the U.S. Congress, and the Basel Committee on Banking Regulation have all introduced regulations to improve the financial strength of the U.S. and international banking community. Such regulation has limited certain activities of banks and also has increased liquidity and capitalization requirements. Several current proposed regulations would implement capitalization requirements that may impact the future availability of repurchase agreement financing which could impact our business model.***

Certain rules proposed by regulators of financial institutions require such financial institutions to maintain minimum amounts of capital relative to its assets. One such proposal was made in June 2013 by the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") to strengthen the leverage ratio standards for the largest, most systemically significant U.S. banking organizations defined as bank holding companies with more than \$700 billion in consolidated total assets or \$10 trillion in assets under custody. Under the proposal, these entities would be required to maintain a tier 1 capital leverage buffer of at least 2 percent above the minimum supplementary leverage ratio requirement of 3 percent, for a total of 5 percent. Such amount is in excess of current required capital levels for these institutions and could force reductions in overall leverage, including repurchase agreement financing, by these institutions in order to comply with the leverage ratio requirement, which could in turn limit the amount available for us to borrow or could increase our overall cost of financing. As of December 31, 2013, we have repurchase agreements outstanding of \$1.1 billion with financial institutions that would be required to comply with this leverage ratio.

***Adverse developments involving major financial institutions or one of our lenders could also result in a rapid reduction in our ability to borrow and adversely affect our business and profitability.***

Since 2008, events in the financial markets relating to major financial institutions have raised concerns that a material adverse development involving one or more major financial institutions could result in our lenders reducing our access to funds available under our repurchase agreements. Such a disruption could cause our lenders to reduce or terminate our access to future borrowings. In such a scenario, we may be forced to sell investments under adverse market conditions. We may also be unable to purchase additional investments without access to additional financing. Either of these events could adversely affect our business and profitability.

***If a lender to us in a repurchase transaction defaults on its obligation to resell the underlying security back to us at the end of the transaction term, or if we default on our obligations under a repurchase agreement, we will incur losses.***

Repurchase agreement transactions are legally structured as the sale of a security to a lender in return for cash from the lender. These transactions are accounted for as financing agreements because the lenders are obligated to resell the same securities back to us at the end of the transaction term. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities, if the lender defaults on its obligation to resell the same securities back to us, we would incur a loss on the transaction equal to the difference between the value of the securities sold and the amount borrowed from the lender. The lender may default on its obligation to resell if it experiences financial difficulty or if the lender has re-hypothecated the security to another party who fails to transfer the security to the lender. Additionally, if we default on one of our obligations under a repurchase agreement, the lender can terminate the transaction, sell the underlying collateral and cease entering into any other repurchase transactions with us. Any losses we incur on our repurchase transactions could adversely affect our earnings and reduce our ability to pay dividends to our shareholders.

***A decrease or lack of liquidity in our investments may adversely affect our business, including our ability to value and sell our assets.***

We invest in securities that are not publicly traded in liquid markets. Though Agency MBS are generally deemed to be a very liquid security, turbulent market conditions in the past have at times significantly and negatively impacted the liquidity of these assets. This has resulted in periods of reduced pricing for Agency MBS from our repurchase agreement lenders. In extreme cases, financing might not be available for certain Agency MBS. Generally, our lenders will value Agency MBS based on liquidation value in periods of significant market volatility. For example, during June and July 2013, we believe that our lenders valued our Agency MBS on a liquidation basis as the market (and our lenders) became concerned with changes in FOMC policy with respect to the targeted Fed Funds rate and its QE program. This resulted in margin calls by our repurchase agreement lenders as the value of the pledged collateral declined.

With respect to non-Agency MBS, such securities typically experience greater price volatility than Agency MBS as there is no guaranty of payment by Fannie Mae and Freddie Mac, and they can be more difficult to value. In addition, third-party pricing for non-Agency MBS may be more subjective than for Agency MBS. As such, non-Agency MBS are typically less liquid than Agency MBS and are subject to a greater risk of repurchase agreement financing not being available, market value reductions, and/or lower advance rates and higher costs from lenders.

Illiquidity in our investment portfolio may make it difficult for us to sell certain investment securities if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded certain of our investment securities which would adversely affect our results of operations and our book value.

***Fluctuations in interest rates may have various negative effects on us and could lead to reduced profitability and a lower book value.***

Fluctuations in interest rates impact us in a number of ways. For example, in a period of rising rates, we may experience a decline in our profitability from borrowing rates increasing faster than our assets reset or from our investments adjusting less frequently or relative to a different index (e.g., six month or one-year LIBOR) from our borrowings (repurchase agreements are typically based on one-month LIBOR). Most of our assets are also fixed rate for a period of their lives and are financed with floating rate repurchase agreements that mature every 30-180 days. In a period of rising rates our borrowings will reset more quickly to market interest rates than most of our assets, which may negatively affect returns on our portfolio and our net interest income.

Fluctuations in interest rates may also negatively affect the market value of our securities. Since our securities are fixed rate or adjust generally over longer-term periods, rising interest rates will reduce the market value of our securities which will reduce book value. In some instances, increases in short-term rates are rapid enough that short-term rates equal or exceed medium/long-term rates, resulting in a flat or inverted yield curve. Any fixed-rate or hybrid ARM investment will generally be more negatively affected by these increases than ARMs (which have interest-rates that adjust more frequently). Reductions in market value of our securities could result in margin calls from our lenders and could result in our being forced to sell securities at a loss. We may also experience a reduction in the market value of our MBS as a result of higher yield requirements by the market for these types of securities. Conversely, while declining interest rates are more favorable for us, we may experience increasing prepayments, resulting in reduced profitability and returns of our capital in lower yielding investments. Such fluctuations could negatively impact our results of operations, and could impact our financial condition and book value.

***Our use of hedging strategies to mitigate our interest rate exposure may not be effective, may adversely affect our income, may expose us to counterparty risks, and may increase our contingent liabilities.***

We may pursue various types of hedging strategies, including interest rate swap agreements, Eurodollar futures, interest rate caps, and other derivative transactions (collectively, “hedging instruments”) to help mitigate increasing financing costs and lower book value from adverse changes in interest rates. Our hedging activity will vary in scope based on our portfolio construction and objectives, the level and volatility of interest rates, and financing sources used. No hedging strategy, however, can completely insulate us from the interest rate risks to which we are exposed, and there can be no assurance that the implementation of any hedging strategy will have the desired impact on our results of operations or financial condition. In addition, hedging instruments that we use may adversely affect our results of operations and book value (particularly if interest rates decline) as the fair value of hedging instruments fluctuate with changes in rates (and require us to post margin to counterparties) and also involve an expense that we will incur regardless of the effectiveness of the hedging activity.

Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- interest rate hedging can be expensive, particularly during periods of volatile interest rates;
- available hedging instruments may not correspond directly with the interest rate risk from which we seek protection;
- the duration of the hedge may not match the duration of the related liability;

- the value of derivatives used for hedging will be adjusted from time to time in accordance with GAAP to reflect changes in fair value, and downward adjustments, or “mark-to-market losses,” would reduce our earnings, shareholders’ equity, and book value;
- the amount of income that a REIT may earn from hedging transactions (other than through taxable REIT subsidiaries) to offset interest rate losses may be limited by U.S. federal income tax provisions governing REITs;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the party owing money in the hedging transaction may default on its obligation to pay.

We expect to primarily use interest rate swap agreements and Eurodollar futures to hedge against anticipated future increases in interest expense from our repurchase agreements. Most of our interest rate swaps and Eurodollars are traded on a regulated exchange or administered through a clearing house. We are required to post margin at the inception of the swap or Eurodollar and also to post variation margin if the fair value of the swap or Eurodollar instrument declines. A portion of our swaps, however, are administered under bilateral agreements between us and a counterparty, exposing us to increased counterparty risk with regard to these interest rate swaps. Should an interest rate swap agreement counterparty be unable to make required payments pursuant to the agreement, the hedged liability would cease to be hedged for the remaining term of the interest rate swap agreement. In addition, we may be at risk of loss of any collateral held by a hedging counterparty to an interest rate swap agreement if the counterparty becomes insolvent or files for bankruptcy. Our hedging transactions, which are intended to limit losses, may actually adversely affect our earnings, which could reduce our ability to pay dividends to our shareholders.

***Clearing facilities or exchanges upon which some of our hedging instruments are traded may increase margin requirements on our hedging instruments in the event of adverse economic developments.***

In response to events having or expected to have adverse economic consequences or which create market uncertainty, clearing facilities or exchanges upon which some of our hedging instruments are traded may require us to post additional collateral against our hedging instruments. For example, in response to the U.S. approaching its debt ceiling without resolution and the federal government shutdown in October 2013, the Chicago Mercantile Exchange announced that it would increase margin requirements by 12% for all over-the-counter interest rate swap portfolios that its clearinghouse guaranteed. This increase was subsequently rolled back shortly thereafter upon the news that Congress passed legislation to temporarily suspend the national debt ceiling, reopened the federal government, and provided a time period for broader negotiations concerning federal budgetary issues. In the event that future adverse economic developments or market uncertainty (including those due to governmental, regulatory, or legislative action or inaction) result in increased margin requirements for our hedging instruments, it could materially adversely affect our liquidity position, business, financial condition and results of operations.

***Interest rate caps on the ARMs collateralizing our investments may adversely affect our profitability if interest rates increase.***

Because the interest rates on the mortgage loans collateralizing ARM securities are typically based on an interest rate index such as LIBOR, the coupons earned on ARM securities adjust over time. The level of adjustment on the interest rates on ARM securities is limited by contract and is based on the limitations of the underlying ARMs. Such mortgage loans typically have interim, or periodic, and lifetime interest rate caps which limit the amount by which the interest rates can adjust. Periodic interest rate caps limit the amount interest rates can adjust during any given period. Lifetime interest rate caps limit the amount interest rates can adjust from inception through maturity of a particular loan. In a sustained period of rising interest rates or a period in which interest rates rise rapidly, interest on our ARM securities could be limited due to the ARM securities reaching their periodic or lifetime interest rate caps. We may experience price volatility as ARM securities approach their caps. We may also experience a decline in our profitability as the repurchase agreements which finance our ARM securities have no periodic or lifetime interest rate caps.

***Our business model depends in part on the continued viability of Fannie Mae and Freddie Mac. Both Fannie Mae and Freddie Mac are currently under conservatorship by the Federal Housing Finance Agency (“FHFA”). As conservator, the FHFA has assumed all the powers of the shareholders, directors and officers of the GSEs with the goal of preserving and conserving their assets. Both Fannie Mae’s and Freddie Mac’s solvency is being supported by the Treasury through their committed purchases of Fannie Mae and Freddie Mac preferred stock. The ultimate impact on the operations of Fannie Mae and Freddie Mac from the conservatorships and the support they receive from the U.S. government is not determinable and could affect Fannie Mae and Freddie Mac in such a way that our business, operations and financial condition may be adversely affected.***

In 2008, the FHFA placed Fannie Mae and Freddie Mac under federal conservatorship. As its conservator, the FHFA has broad regulatory powers over Fannie Mae and Freddie Mac and has entered into Preferred Stock Purchase Agreements, as amended, ("PSPAs") pursuant to which the Treasury ensures that Fannie Mae and Freddie Mac will separately maintain a positive net worth by committing to purchase preferred stock of Fannie Mae and Freddie Mac. Since then, the U.S Treasury has injected an aggregate of \$188 billion in capital into the GSEs in order that they remain solvent.

The problems faced by Fannie Mae and Freddie Mac, which resulted in their placement into federal conservatorship and receipt of significant U.S. government support, have sparked debate among federal policy makers regarding the continued role of the U.S. government in providing liquidity for mortgage loans and Agency MBS. The FHFA as the regulator of the GSEs has proposed several reforms including building a common, single, securitization platform between the two entities and gradually contracting their presence in the mortgage marketplace.

In addition, the U.S. Congress has been considering structural changes to the GSEs with the most prominent proposal being made by Senators Robert Corker of Tennessee and Mark Warner of Virginia. Senators Corker and Warner introduced legislation in June 2013 titled the Corker-Warner Housing Finance Reform and Taxpayer Protection Act (the "Corker-Warner Bill") that would replace the GSEs with a privately capitalized system that is intended to preserve market liquidity and protect taxpayers from future GSE losses due to economic downturns. The Corker-Warner Bill would wind down the GSEs within 5 years and create an alternative structure to provide catastrophic reinsurance, among other provisions. It is unclear if any proposals made by the FHFA or by members of the U.S Congress, including the Corker-Warner Bill, will be enacted or implemented in any form. With Fannie Mae's and Freddie Mac's future under debate, the nature of their future guarantee obligations could be considerably limited. Any changes to the nature of their guarantee obligations could redefine what constitutes an Agency MBS and could have broad adverse implications for the market and our business, operations and financial condition. If Fannie Mae or Freddie Mac are eliminated, or their structures change significantly (e.g., limitation or removal of the guarantee obligation), we may be unable to acquire additional Agency MBS. This would remove a material component of our investment strategy and would make it more difficult for us to comply with the provisions of the 1940 Act (see further discussion below regarding the 1940 Act).

Both Fannie Mae and Freddie Mac have returned to profitability as a result of the housing market recovery, but their business model is still highly leveraged to the strength of the housing market in the U.S. We believe that the market perceives that these entities will be unable to meet their obligations unless they remain in conservatorship. If Fannie Mae and Freddie Mac were unwilling or unable to honor the guarantee of payment on Agency MBS, or were perceived to be less likely to honor fully such guarantees, we could potentially incur substantial losses on such securities and experience extreme market price volatility. We rely on our Agency MBS as collateral for our financings under our repurchase agreements. Any decline in their value, or perceived market uncertainty about their value, would make it more difficult for us to obtain financing on acceptable terms or at all, or to maintain our compliance with the terms of any financing transactions. Future policies that change the relationship between Fannie Mae and Freddie Mac and the U.S. government, including those that result in their winding down, nationalization, privatization, or elimination, may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae and Freddie Mac. As a result, such policies could increase the risk of loss on investments in Agency MBS guaranteed by Fannie Mae and/or Freddie Mac. It also is possible that such policies could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially and adversely affect our business, operations and financial condition.

***Changes in prepayment rates on the mortgage loans underlying our investments may adversely affect our profitability and the market value of our investments. Changes in prepayment rates also subject us to reinvestment risk.***

Our investments subject us to prepayment risk to the extent that we own them at premiums to their par value. We use the effective yield method of accounting for amortization of premiums which is impacted by actual and projected borrower prepayments of principal on the loans (whether on a voluntary or involuntary basis) underlying our investments. If we experience actual prepayments in excess of forecasts or increase our expectations of future prepayment activity, we will amortize premiums on investments on an accelerated basis which may adversely affect our profitability.

Prepayments occur on both a voluntary or involuntary basis. Voluntary prepayments tend to increase when interest rates are declining or, in the case of ARMs or hybrid ARMs, based on the shape of the yield curve. CMBS in which we invest generally are protected in the case of voluntary prepayments either from absolute prepayment lock-out on the loan or compensation for

future lost interest income on the loan through yield maintenance payments or prepayment penalties. The actual level of prepayments will be impacted by economic and market conditions, including new loan underwriting requirements. Involuntary prepayments tend to increase in periods of economic stress and may occur for any of our investment types.

The value of our RMBS assets is affected by prepayment rates on the mortgage loans underlying the RMBS, and our investment strategy includes making investments based on our expectations regarding prepayment rates. Prepayment rates that are faster than anticipated may increase or decrease the value of a security, depending on the type of security and the price paid to acquire the security, and will impact the yield on the security. Prepayment rates may be affected by a number of factors including but not limited to the availability of mortgage credit, interest rate and loan refinancing activity, the relative economic vitality of the area in which the related properties are located, the average remaining life of the loans, the average size of the remaining loans, the availability and relative attractiveness of government programs (as further discussed below), the servicing of the mortgage loans, possible changes in tax laws, other opportunities for investment, homeowner mobility, and other economic, social, geographic, demographic and legal factors. Consequently, such prepayment rates cannot be predicted with any certainty. In making investment decisions, we depend on certain assumptions based upon historical trends with respect to the relationship between interest rates and prepayments under normal market conditions. If regulatory changes, dislocations in the residential mortgage market, or other developments change the way that prepayment trends have historically responded to interest rate changes, our ability to predict or make assumptions regarding prepayment rates, assess the market value of target assets, implement hedging strategies and implement techniques to hedge prepayment risks would be significantly affected, which could materially adversely affect our financial position and results of operations. If we make erroneous assumptions regarding prepayment rates, we may experience significant investment losses.

If we receive increased prepayments of our principal in a declining or low interest rate environment, we may earn a lower return on our new investments as compared to the MBS that prepay given the declining interest rate environment. If we reinvest our capital in lower yielding investments, we will likely have lower net interest income and reduced profitability unless the cost of financing these investments declines faster than the rate at which we may reinvest.

***The Treasury and Congress continue to seek ways to support the U.S. housing market and the overall U.S. economy, including seeking ways to make it easier to refinance loans owned or guaranteed by Fannie Mae or Freddie Mac where the borrower may have negative equity. In addition, mortgage loan modification programs and future legislative action may adversely affect the value of and the return on Agency RMBS securities in which we invest. Since we own our Agency RMBS at premiums to their par balance, we could incur substantial losses on our Agency RMBS if mortgage loan refinancings increased.***

The Treasury and the Department of Housing and Urban Development ("HUD") have implemented the Home Affordable Refinance Program (or "HARP"), which allows borrowers who are current on their mortgage payments to refinance loans originated on or before May 31, 2009, with current loan-to-value ratios exceeding 80%, in order to reduce their monthly mortgage payments. HARP specifically targets borrowers that are current on their mortgage payment but who have negative equity in their home and, as a result, have been unable to refinance into a lower cost mortgage (given the decline in current mortgage rates compared to pre-May 31, 2009). HARP currently is set to expire on December 31, 2015. Many of our Agency RMBS that are collateralized by mortgage loans whose coupons exceed current mortgage interest rates are owned at premiums to their par balance. In September 2013, the FHFA announced a national education campaign to reach eligible homeowners in an effort to expand the success of HARP. If refinance activity increases for Agency RMBS as a result of HARP or other government programs or efforts, or if we increase forecasted prepayments on our Agency RMBS, our net interest income would be negatively impacted by the additional amortization of premium on our Agency RMBS. In addition, we may experience significant volatility in the market value of Agency RMBS as the market resets prepayment expectations on Agency RMBS. Such volatility could lead to margin calls from our repurchase agreement lenders and could force us to sell these securities under unfavorable conditions and possibly at a loss.

The Treasury and HUD have also created a number of different programs intended to assist borrowers that are struggling to make their mortgage payment that may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans (through forbearance and/or forgiveness) and/or the rate of interest payable on the loans, or to extend the payment terms of the loans. Loan modifications such as these could result in our ultimately receiving less than we are contractually due on certain of our investments. A significant number of loan modifications with respect to a given security could negatively impact the realized yields and cash flows on such security. These loan modification programs, future legislative or regulatory actions, including new mortgage loan modification programs and possible amendments to the bankruptcy laws, which result in the modification of outstanding residential mortgage loans, as well as changes in the requirements necessary to qualify for

refinancing mortgage loans with Fannie Mae, Freddie Mac or Ginnie Mae, may adversely affect the value of, and the returns on, our securitized single-family mortgage loans and Agency RMBS.

***We invest in interest only ("IO") derivative securities issued by CMBS securitization trusts which are backed principally by multifamily mortgage loans. We could lose some or all of our investment in CMBS IO securities if the loans in the CMBS securitization trusts unexpectedly prepay.***

CMBS IO securities have no principal amounts outstanding and consist only of the right to receive excess interest payments on the underlying CMBS loans included in the securitization trust. We could lose some or all of our investment in our IO securities if the underlying loans in the CMBS default and are liquidated, restructured or are otherwise repaid or refinanced prior to their expected repayment date. Such an event would cause our net income to decline and could also result in declines in market prices on our CMBS IO securities, thereby reducing our book value, resulting in margin calls from repurchase agreement lenders, and adversely affecting our financial condition. In addition, loans underlying the CMBS may be protected from voluntary prepayment through lock-out, yield maintenance, or prepayment penalty provisions. In certain IO securities, yield maintenance or prepayment penalties may not be sufficient to compensate us for the loss of future excess interest as a result of the prepayment, thereby adversely affecting our results of operations. Also, the amount of prepayment penalties required to be paid decline over time, and as loans age, interest rates decline, or market values of the collateral supporting the loan increase, prepayment penalties may not serve as a meaningful economic disincentive to the borrower.

***Provisions requiring yield maintenance charges, prepayment penalties, defeasance or lock-outs in CMBS IO securities may not be enforceable.***

Provisions in loan documents for mortgages in CMBS IO securities in which we invest requiring yield maintenance charges, prepayment penalties, defeasance or lock-out periods may not be enforceable in some states and under federal bankruptcy law. Provisions in the loan documents requiring yield maintenance charges and prepayment penalties may also be interpreted as constituting the collection of interest for usury purposes. Accordingly, we cannot be assured that the obligation of a borrower to pay any yield maintenance charge or prepayment penalty under a loan document in a CMBS IO security will be enforceable. Also, we cannot be assured that foreclosure proceeds under a loan document in a CMBS IO security will be sufficient to pay an enforceable yield maintenance charge. If yield maintenance charges and prepayment penalties are not collected, or if a lock-out period is not enforced, we may incur losses to write-down the value of the CMBS IO security for the present value of the amounts not collected. This would also likely cause margin calls from any lender on the CMBS IO impacted.

***We invest in commercial mortgage loans and CMBS collateralized by commercial mortgage loans which are secured by income producing properties. Such loans are typically made to single-asset entities, and the repayment of the loan is dependent principally on the net operating income from performance and value of the underlying property. The volatility of income performance results and property values may adversely affect our commercial mortgage loans and CMBS.***

Our commercial mortgage loans and CMBS are secured by multifamily and commercial property and are subject to risks of delinquency, foreclosure, and loss. Commercial mortgage loans generally have a higher principal balance and the ability of a borrower to repay a loan secured by an income-producing property typically is dependent upon the successful operation of the property rather than upon the existence of independent income or assets of the borrower. If the net operating income of the property is reduced, the borrower's ability to repay the loan may be impaired. Net operating income of an income-producing property can be affected by, among other things: tenant mix, success of tenant businesses, property management decisions, property location and condition, competition from comparable types of properties, changes in laws that increase operating expenses or limit rents that may be charged, any need to address environmental contamination at the property, changes in national, regional or local economic conditions and/or specific industry segments, declines in regional or local real estate values and declines in regional or local rental or occupancy rates, increases in interest rates, real estate tax rates and other operating expenses, changes in governmental rules, regulations and fiscal policies, including environmental legislation, and acts of God, terrorism, social unrest and civil disturbances.

Commercial and multifamily property values and net operating income derived from them are subject to volatility and may be affected adversely by a number of factors, including, but not limited to, national, regional and local economic conditions; local real estate conditions; changes or continued weakness in specific industry segments; perceptions by prospective tenants, retailers and shoppers of the safety, convenience, services and attractiveness of the property; the willingness and ability of the

property's owner to provide capable management and adequate maintenance; construction quality, age and design; demographic factors; retroactive changes to building or similar codes; and increases in operating expenses (such as energy costs).

Declines in the borrowers' net operating income and/or declines in property values of collateral securing commercial mortgage loans could result in defaults on such loans, declines in our book value from reduced earnings and/or reductions to the market value of the investment.

***Credit ratings assigned to debt securities by the credit rating agencies may not accurately reflect the risks associated with those securities. Changes in credit ratings for securities we own or for similar securities might negatively impact the market value of these securities.***

Rating agencies rate securities based upon their assessment of the safety of the receipt of principal and interest payments on the securities. Rating agencies do not consider the risks of fluctuations in fair value or other factors that may influence the value of securities and, therefore, the assigned credit rating may not fully reflect the true risks of an investment in securities. Also, rating agencies may fail to make timely adjustments to credit ratings based on available data or changes in economic outlook or may otherwise fail to make changes in credit ratings in response to subsequent events, so our investments may be better or worse than the ratings indicate. We attempt to reduce the impact of the risk that a credit rating may not accurately reflect the risks associated with a particular debt security by not relying solely on credit ratings as the indicator of the quality of an investment. We make our acquisition decisions after factoring in other information that we have obtained about the loans underlying the security and the credit subordination structure of the security. Despite these efforts, our assessment of the quality of an investment may also prove to be inaccurate and we may incur credit losses in excess of our initial expectations.

Credit rating agencies may change their methods of evaluating credit risk and determining ratings on securities backed by real estate loans and securities. These changes may occur quickly and often. The market's ability to understand and absorb these changes, and the impact to the securitization market in general, are difficult to predict. Such changes may have a negative impact on the value of securities that we own.

***Our ownership of securitized mortgage loans subjects us to credit risk and, although we provide for an allowance for loan losses on these loans as required under GAAP, the loss reserves are based on estimates. As a result, actual losses incurred may be larger than our reserves, requiring us to provide additional reserves, which would impact our financial position and results of operations.***

We are subject to credit risk as a result of our ownership of securitized mortgage loans. Credit risk is the risk of loss to us from the failure by a borrower (or the proceeds from the liquidation of the underlying collateral) to fully repay the principal balance and interest due on a mortgage loan. A borrower's ability to repay the loan and the value of the underlying collateral could be negatively impacted by economic and market conditions. These conditions could be global, national, regional or local in nature.

We provide reserves for losses on securitized mortgage loans based on the current performance of the respective pool or on an individual loan basis. If losses are experienced more rapidly due to declining property performance, market conditions or other factors, than we have provided for in our reserves, we may be required to provide additional reserves for these losses. In addition, our allowance for loan losses is based on estimates and to the extent that proceeds from the liquidation of the underlying collateral are less than our estimates, we will record a reduction in our profitability for that period equal to the shortfall.

***Our efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans or losses on our investments. If we experience higher than anticipated delinquencies and defaults, our earnings, our book value and our cash flow may be negatively impacted.***

There are many aspects of credit performance for our investments that we cannot control. Third party servicers provide for the primary and special servicing of our single-family and commercial mortgage loans and non-Agency MBS. In that capacity these service providers control all aspects of loan collection, loss mitigation, default management and ultimate resolution of a defaulted loan. We have a risk management function which oversees the performance of these servicers and provides limited asset management services. Loan servicing companies may not cooperate with our risk management efforts, or such efforts may be ineffective. We have no contractual rights with respect to these servicers and our risk management operations may not be successful in limiting future delinquencies, defaults, and losses.



The securitizations in which we have invested may not receive funds that we believe are due from mortgage insurance companies and other counterparties. Service providers to securitizations, such as trustees, bond insurance providers, guarantors and custodians, may not perform in a manner that promotes our interests or may default on their obligation to the securitization trust. The value of the properties collateralizing the loans may decline causing higher losses than anticipated on the liquidation of the property. The frequency of default and the loss severity on loans that do default may be greater than we anticipated. If loans become “real estate owned” (“REO”), servicing companies will have to manage these properties and may not be able to sell them at reasonable prices. Changes in consumer behavior, bankruptcy laws, tax laws, and other laws may exacerbate loan losses. In some states and circumstances, the securitizations in which we invest have recourse, as the owner of the loan, against the borrower’s other assets and income in the event of loan default; however, in most cases, the value of the underlying property will be the sole source of funds for any recoveries.

***Guarantors may fail to perform on their obligations to our securitization trusts, which could result in additional losses to us.***

In certain instances we have guaranty of payment on commercial and single-family mortgage loans pledged to securitization trusts (see Item 7A, “Quantitative and Qualitative Disclosures About Market Risk”). These guarantors have reported substantial losses since 2007, eroding their respective capital bases and potentially adversely impacting their ability to make payments where required. Generally the guarantors will only make payment in the event of the default and liquidation of the collateral supporting the loan. If these guarantors fail to make payment, we may experience losses on the loans that we otherwise would not have experienced.

***We may be subject to the risks associated with inadequate or untimely services from third-party service providers, which may harm our results of operations. We also rely on corporate trustees to act on behalf of us and other holders of securities in enforcing our rights.***

Our loans and loans underlying non-Agency MBS we own are serviced by third-party service providers. Should a servicer experience financial difficulties, it may not be able to perform these obligations. Due to application of provisions of bankruptcy law, servicers who have sought bankruptcy protection may not be required to make advance payments required under the terms of the MBS of amounts due from loan borrowers. Even if a servicer were able to advance amounts in respect of delinquent loans, its obligation to make the advances may be limited to the extent that it does not expect to recover the advances due to the deteriorating credit of the delinquent loans. In addition, as with any external service provider, we are subject to the risks associated with inadequate or untimely services for other reasons. Servicers may not advance funds to us that would ordinarily be due because of errors, miscalculations, or other reasons. Many borrowers require notices and reminders to keep their loans current and to prevent delinquencies and foreclosures, which our servicers may fail to provide. A substantial increase in our delinquency rate resulting from improper servicing or loan performance in general may result in credit losses.

We also rely on corporate trustees to act on behalf of us and other holders of securities in enforcing our rights. Under the terms of most securities we hold we do not have the right to directly enforce remedies against the issuer of the security, but instead must rely on a trustee to act on behalf of us and other security holders. Should a trustee not be required to take action under the terms of the securities, or fail to take action, we could experience losses.

***Global sovereign credit risk could have a material adverse effect on our business, financial condition and liquidity.***

Sovereign credit in the United States and Europe is currently under pressure as a result of large budget deficits, fiscal imbalances and below trend growth or negative growth. While we do not borrow directly from any sovereign, global risk appetite is impacted by changes in actual or perceived credit risk of the United States, Europe and Asia. Adverse changes in sovereign credit ratings could have a material adverse impact on financial markets and economic conditions in the United States and worldwide, and on the availability of financing as well as the price of securities that we own. Any such adverse impact could have a material adverse effect on our liquidity, financial condition and results of operations.

In addition, since Fannie Mae and Freddie Mac are under conservatorship of the U.S. government which is supporting their solvency, it is unclear if any downgrade in the credit of the U.S. government would impact its ability to maintain the solvency of these entities. In such a case, the ability of Fannie Mae and Freddie Mac to perform pursuant to their guarantees on Agency

MBS may be severely limited which could have a material adverse effect on our liquidity, financial condition and results of operations.

***We may change our investment strategy, operating policies, dividend policy and/or asset allocations without shareholder consent.***

We may change our investment strategy, operating policies, dividend policy and/or asset allocation with respect to investments, acquisitions, leverage, growth, operations, indebtedness, capitalization and distributions at any time without the consent of our shareholders. A change in our investment strategy may increase our exposure to interest rate and/or credit risk, default risk and real estate market fluctuations. Furthermore, a change in our asset allocation could result in our making investments in asset categories different from our historical investments. These changes could adversely affect our financial condition, results of operations, the market price of our common stock or our ability to pay dividends to our shareholders.

***Competition may prevent us from acquiring new investments at favorable yields, and we may not be able to achieve our investment objectives which may potentially have a negative impact on our profitability.***

Our net income will largely depend on our ability to acquire mortgage-related assets at favorable spreads over our borrowing costs. The availability of mortgage-related assets meeting our investment criteria depends upon, among other things, the level of activity in the real estate market and the quality of and demand for securities in the mortgage securitization and secondary markets. The size and level of activity in real estate lending markets depends on various factors, including interest rates, regional and national economic conditions and real estate values. In acquiring investments, we may compete with other purchasers of these types of investments, including but not limited to other mortgage REITs, broker-dealers, hedge funds, banks, savings and loans, insurance companies, mutual funds, and other entities that purchase assets similar to ours, many of which have greater financial resources than we do. As a result of all of these factors, we may not be able to acquire sufficient assets at acceptable spreads to our borrowing costs, which would adversely affect our profitability.

In order to maintain our portfolio size and our earnings, we must reinvest the cash flows we receive from our existing investment portfolio, including monthly principal and interest payments and proceeds from sales. If the assets we acquire in the future earn lower yields than the assets we currently own, our reported earnings per share will likely decline over time as the older assets pay down or are sold. The risk that newly-acquired investments will not generate yields as attractive as yields on our current assets has been exacerbated in recent quarters due to the very low interest rate environment, Federal Reserve monetary policy and open market purchases of assets, and increased competition for investment securities. In addition, in light of our investment portfolio and market conditions, we may decide to not reinvest the cash flows we receive from our existing investment portfolio. If we retain, rather than reinvest, these cash flows, the size of our investment portfolio and interest income generated by our investment portfolio will likely decline.

***Any failure of U.S. lawmakers in the future to reach an agreement on a budget for the federal government or negative perceptions of the U.S. government's fiscal health may lead to a downgrade of the U.S. credit rating or a perceived increase of risk of a default on U.S. government obligations, which could materially adversely affect our business, financial condition and results of operations.***

The U.S. government's fiscal health has been a source of debate and concern of market participants and U.S. lawmakers. Any perception that the U.S. is unable or unwilling to honor its obligations could have a material negative impact on U.S. government securities and in turn, the value of our investment portfolio and our ability to obtain financing for our investments. Thus, a default or the perception of a possibility of default by the U.S. government on its obligations may materially adversely affect our business, financial condition and results of operations.

On August 5, 2011, Standard & Poor's downgraded the U.S. credit rating to AA+ for the first time due to the U.S. Congress' inability to reach an effective agreement on the national debt ceiling and a federal budget in a timely manner. Because Fannie Mae and Freddie Mac are in conservatorship of the U.S. government, the implicit credit rating of Agency RMBS guaranteed by Freddie Mac, Fannie Mae or Ginnie Mae was also downgraded to AA+. While this downgrade did not have a significant impact on the fair value of the Agency RMBS in our portfolio, it increased the uncertainty regarding the credit risk of Agency RMBS. The current federal budget deficit concerns have increased the possibility of the credit-rating agencies further downgrading the U.S. credit rating. On October 15, 2013, Fitch Ratings Service placed the U.S. credit rating on negative watch, warning that a failure by the U.S. government to honor interest or principal payments on U.S. Treasury Securities would impact its decision whether downgrade

the U.S. credit rating. Fitch also stated that the manner and duration of an agreement to raise the government's debt ceiling and resolve the federal budget impasse, as well as the perceived risk of such events occurring in the future, would weigh on its ratings.

A further downgrade of the U.S. government's credit rating could create broader financial turmoil and uncertainty, which would weigh heavily on the global banking and financial systems. Such circumstances could adversely affect our business in many ways, including but not limited to adversely impacting our ability to obtain financing for our investments, and increasing the cost of such financing if it is obtained. In addition, a further downgrade could increase the likelihood that our repurchase agreement lenders require that we post additional collateral as a result of margin calls, which could cause us to sell assets at depressed prices in order to generate liquidity to satisfy these margin calls, or that we could be forced to sell assets to settle repurchase agreement obligations if we are unable to obtain new repurchase agreement borrowings when our current borrowings expire. As a result, these adverse economic and market conditions may also adversely affect our liquidity position, and could increase our risk of a counterparty defaulting on its obligations. If any of these events were to occur, it could materially adversely affect our business, financial condition and results of operations.

#### **Risks Related to Regulatory and Legal Requirements**

***The effect of legislative and regulatory changes, including the Dodd-Frank Act and regulations implementing it, on our business, the mortgage industry and the markets in which we invest is uncertain, and may be adverse to our business, results of operations and financial condition.***

The Dodd-Frank Wall Street Reform and Consumer Protection Act, or the Dodd-Frank Act, was signed into law in July 2010, and significantly changes the regulation of financial institutions and the financial services industry, including the mortgage industry. The Dodd-Frank Act tasks many agencies with issuing a variety of new regulations, including rules related to mortgage origination and servicing, securitization and derivatives. Because a number of regulations under the Dodd-Frank Act have yet to be proposed or adopted, it is not yet known how these additional regulations will ultimately affect the borrowing environment, the investing environment for MBS, or interest rate swaps and other derivatives. Consequently, it is not possible for us to predict how additional regulation pursuant to the Dodd-Frank Act will affect our business, and there can be no assurance that the Dodd-Frank Act will not have an adverse impact on our business, results of operations or financial condition.

In addition, there is an ongoing debate over the degree and kind of regulation that should be applied to entities that participate in what is popularly referred to as "shadow banking." While there is no authoritative definition of what "shadow banking" is, it generally refers to financial intermediation involving entities and activities outside of the traditional depository banking system, such as mortgage REITs, repurchase agreement financing, securitizations, private equity funds and hedge funds. A general policy concern is that an aspect or component of shadow banking that is not subject to banking regulation - such as safety and soundness regulation and capital requirements - or other government oversight could be a source of financial instability or pose systemic risk to the broader banking and financial markets.

In August 2013, the Financial Stability Board, an international body of which the United States is a member, issued policy recommendations to strengthen oversight and regulation of shadow banking. The policy recommendations outlined initial steps to define the scope of the shadow banking system and proposed general governing principles for a monitoring and regulatory framework, including a "toolkit" of potential regulatory responses that national regulators could employ to reduce systemic risk. While at this stage it is difficult to predict the type and scope of any new regulations that may be adopted by member countries, including the United States, if such regulations were to extend the regulatory and supervisory requirements currently applicable to banks, such as capital and liquidity standards, to our business or that of our financing counterparties or mortgage originators, or were to otherwise classify all or a portion of our business (including financing strategy) as shadow banking, our regulatory and operating costs, particularly borrowing costs, could increase, which may have a material adverse effect on our business.

***Adoption of the Basel III standards and other proposed supplementary regulatory standards may negatively impact our access to financing or affect the terms of our future financing arrangements.***

In response to various financial crises and the volatility of financial markets, the Basel Committee on Banking Supervision adopted the Basel III regulatory capital framework ("Basel III" or the "Basel III standards"). The final package of Basel III reforms was approved by the G20 leaders in November 2010. In January 2013, the Basel Committee agreed to delay implementation of the Basel III standards and expanded the scope of assets permitted to be included in certain banks' liquidity measurements. U.S.

banking regulators have elected to implement substantially all of the Basel III standards. Basel III will be incrementally implemented beginning in 2014 through 2019; such implementation could cause an increase in capital requirements for, and could place constraints on, the financial institutions from which we borrow.

Shortly after approving the Basel III standards, U.S. regulators also issued a notice of proposed rule-making calling for enhanced supplement leverage ratio standards, which would impose capital requirements more stringent than those of the Basel III standards for the most systematically significant banking organizations in the U.S. The enhanced standards are currently subject to public comment, and there can be no assurance that they will be adopted or, if adopted, that they will resemble the current proposal. Adoption and implementation of the supplemental leverage standards proposed by U.S. regulators may negatively impact our access to financing or affect the terms of our future financing arrangements. The supplemental leverage standards as proposed also have an implementation date of 2019, with preliminary reporting required earlier in 2015. We believe most of the systemically significant banking organizations already comply with these leverage ratio standards. Nonetheless, we believe the actual implementation of these standards will reduce the amount of availability of repurchase agreement financing and will increase our financing costs.

***Clearing facilities or exchanges upon which some of our hedging instruments are traded may increase margin requirements on our hedging instruments in the event of adverse economic developments.***

In response to events having or expected to have adverse economic consequences or which create market uncertainty, clearing facilities or exchanges upon which some of our hedging instruments, such as interest rate caps and swaps, are traded may require us to post additional collateral against our hedging instruments. For example, in response to the U.S. approaching its debt ceiling without resolution and the federal government shutdown, the Chicago Mercantile Exchange announced on October 15, 2013 that it would increase margin requirements by 12% for all over-the-counter interest rate swap portfolios that its clearinghouse guaranteed. This increase was subsequently rolled back on October 17, 2013 upon the news that Congress passed legislation to temporarily suspend the national debt ceiling and reopen the federal government, and provide a time period for broader negotiations concerning federal budgetary issues. In the event that future adverse economic developments or market uncertainty - including developments or uncertainty due to governmental, regulatory, or legislative action or inaction - result in increased margin requirements for our hedging instruments, it could materially adversely affect our liquidity position, business, financial condition and results of operations.

#### **Risks Specific to Our REIT Status**

***Qualifying as a REIT involves highly technical and complex provisions of the Code, and a technical or inadvertent violation could jeopardize our REIT qualification. Maintaining our REIT status may reduce our flexibility to manage our operations.***

Qualification as a REIT involves the application of highly technical and complex Code provisions for which only limited judicial and administrative authorities exist. Even a technical or inadvertent violation could jeopardize our REIT qualification. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis. Our operations and use of leverage also subjects us to interpretations of the Code, and technical or inadvertent violations of the relevant requirements under the Code could cause us to lose our REIT status or to pay significant penalties and interest. In addition, our ability to satisfy the requirements to qualify as a REIT depends in part on the actions of third parties over which we have no control or only limited influence, including in cases where we own an equity interest in an entity that is classified as a partnership for U.S. federal income tax purposes.

Maintaining our REIT status may limit flexibility in managing our operations. For instance:

- If we make frequent asset sales from our REIT entities to persons deemed customers, we could be viewed as a “dealer,” and thus subject to 100% prohibited transaction taxes or other entity level taxes on income from such transactions.
- Compliance with the REIT income and asset requirements may limit the type or extent of hedging that we can undertake.
- Our ability to own non-real estate related assets and earn non-real estate related income is limited. Our ability to own equity interests in other entities is limited. If we fail to comply with these limits, we may be forced to liquidate attractive assets on short notice on unfavorable terms in order to maintain our REIT status.

- Our ability to invest in taxable subsidiaries is limited under the REIT rules. Maintaining compliance with this limitation could require us to constrain the growth of future taxable REIT affiliates.
- Notwithstanding our NOL carryforward, meeting minimum REIT dividend distribution requirements could reduce our liquidity. Earning non-cash REIT taxable income could necessitate our selling assets, incurring debt, or raising new equity in order to fund dividend distributions.
- Stock ownership tests may limit our ability to raise significant amounts of equity capital from one source.

***If we do not qualify as a REIT or fail to remain qualified as a REIT, we may be subject to tax as a regular corporation and could face a tax liability, which would reduce the amount of cash available for distribution to our shareholders.***

We intend to operate in a manner that will allow us to qualify as a REIT for federal income tax purposes. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis. Our ability to satisfy the asset tests depends upon our analysis of the characterization and fair market values of our assets, some of which are not susceptible to a precise determination, and for which we will not obtain independent appraisals. Our compliance with the REIT income and quarterly asset requirements also depends upon our ability to successfully manage the composition of our income and assets on an ongoing basis.

If we were to fail to qualify as a REIT in any taxable year, we would be subject to federal income tax, after consideration of our NOL carryforward but not considering any dividends paid to our shareholders during the respective tax year. If we could not otherwise offset this taxable income with our NOL carryforward, the resulting corporate tax liability could be material to our results and would reduce the amount of cash available for distribution to our shareholders, which in turn could have an adverse impact on the value of our common stock. Unless we were entitled to relief under certain Code provisions, we also would be disqualified from taxation as a REIT until the fifth taxable year following the year for which we failed to qualify as a REIT.

***Our future use of our tax NOL carryforward is limited under Section 382 of the Code, which could result in higher taxable income and greater distribution requirements in order to maintain our REIT status. Further, if we unknowingly undergo another ownership change pursuant to Section 382, or miscalculate the limitations imposed by a known ownership change, and utilize an impermissible amount of the NOL, we may fail to meet the distribution requirements of a REIT and therefore we could lose our REIT status.***

We can use our tax NOL carryforward to offset our taxable earnings after taking the REIT distribution requirements into account. Section 382 of the Code limits the amount of NOL that could be used to offset taxable earnings after an “ownership change” occurs. A Section 382 ownership change generally occurs if one or more shareholders who own at least 5% of our stock, or certain groups of shareholders, increase their aggregate ownership by more than 50 percentage points over their lowest ownership percentage within a rolling three-year period.

Our public offering of common stock in February 2012 resulted in an ownership change under Section 382. Based on management's analysis and expert third-party advice, which necessarily includes certain assumptions regarding the characterization under Section 382 of our use of capital raised by us, we determined that the ownership change under Section 382 will limit our ability to use our NOL carryforward to offset our taxable income to an estimated maximum amount of \$13.5 million per year. Because NOLs generally may be carried forward for up to 20 years, this annual limitation may effectively limit the cumulative amount of pre-ownership change losses, including certain recognized built-in losses, that we may utilize. This would result in higher taxable income and greater distribution requirements in order to maintain REIT qualification than if such limitation were not in effect.

We may incur additional ownership changes under Section 382 in the future, in which case the use of our NOL could be further limited. Future issuances or sales of our stock (including transactions involving our stock that are out of our control) could result in an ownership change under Section 382. If further ownership changes occur, Section 382 would impose stricter annual limits on the amount of pre-ownership change NOLs and other losses we could use to reduce our taxable income.

If we unknowingly undergo another ownership change under Section 382, or miscalculate the limitations imposed by a known ownership change, the use of the NOL could be limited more than we have determined and we may utilize (or may have utilized) more of the NOL than we otherwise may have been allowed. In such an instance we may be required to pay taxes, penalties and interest on the excess amount of NOL used, or we may be required to declare a deficiency dividend to our shareholders for

the excess amount. In addition, if any impermissible use of the NOL led to a failure to comply with the REIT distribution requirements, we could fail to qualify as a REIT.

***The failure of investments subject to repurchase agreements to qualify as real estate assets could adversely affect our ability to qualify as a REIT.***

Repurchase agreement financing arrangements are structured legally as a sale and repurchase whereby we sell certain of our investments to a counterparty and simultaneously enter into an agreement to repurchase these securities at a later date in exchange for a purchase price. Economically, these agreements are financings which are secured by the investments sold pursuant thereto. We believe that we would be treated for REIT asset and income test purposes as the owner of the securities that are the subject of any such sale and repurchase agreement, notwithstanding that such agreements may legally transfer record ownership of the securities to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the securities during the term of the sale and repurchase agreement, in which case we could fail to qualify as a REIT.

***Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flow and our profitability.***

Even if we remain qualified for taxation as a REIT, we may be subject to certain federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure or considered prohibited transactions under the Code, and state or local income taxes. Any of these taxes would decrease cash available for distribution to our shareholders. In addition, in order to meet the REIT qualification requirements, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from prohibited transactions, we may hold some of our assets through a taxable REIT subsidiary ("TRS") or other subsidiary corporations that will be subject to corporate-level income tax at regular rates to the extent that such TRS does not have an NOL carryforward. Any of these taxes would decrease cash available for distribution to our shareholders.

***If we fail to maintain our REIT status, our ability to utilize repurchase agreements as a source of financing and to enter into interest rate swap agreements may be impacted.***

Most of our repurchase agreements and the agreements governing our interest rate swaps require that we maintain our REIT status as a condition to engaging in a transaction with us. Even though repurchase agreements generally are not committed facilities with our lenders, if we failed to maintain our REIT status our ability to enter into new repurchase agreement transactions or renew existing, maturing repurchase agreements will likely be limited. Some of our repurchase agreements and swap agreements have cross-default provisions which provide for lenders to terminate these agreements if we default under any of our repurchase agreements or swap agreements. As such, we may be required to sell investments, potentially under adverse circumstances, that were previously financed with repurchase agreements and we may be forced to terminate our interest rate swap agreements.

***Certain of our securitization trusts that qualify as "taxable mortgage pools" require us to maintain equity interests in the securitization trusts. If we do not, our profitability and cash flow may be reduced.***

Certain of our securitization trusts are considered taxable mortgage pools for federal income tax purposes. These securitization trusts are exempt from taxes so long as we, or another REIT, own 100% of the equity interests in the trusts. If we fail to maintain sufficient equity interest in these securitization trusts or if we fail to maintain our REIT status, then the trusts may be considered separate taxable entities. If the trusts are considered separate taxable entities, they will be required to compute taxable income and pay tax on such income. Our profitability and cash flow will be impacted by the amount of taxes paid. Moreover, we may be precluded from selling equity interests, including debt securities issued in connection with these trusts that might be considered to be equity interests for tax purposes, to certain outside investors.

**Risks Related to the Investment Company Act of 1940 (the "1940 Act")**

***If we fail to properly conduct our operations we could become subject to regulation under the 1940 Act. Conducting our business in a manner so that we are exempt from registration under and compliance with the 1940 Act may reduce our flexibility and could limit our ability to pursue certain opportunities.***

We seek to conduct our operations so as to avoid falling under the definition of an investment company pursuant to the 1940 Act. Specifically, we seek to conduct our operations under the exemption provided under Section 3(c)(5)(C) of the 1940 Act, a provision available to companies primarily engaged in the business of purchasing and otherwise acquiring mortgages and other liens on and interests in real estate. According to SEC no-action letters, companies relying on this exemption must ensure that at least 55% of their assets are mortgage loans and other qualifying assets, and at least 80% of their assets are real estate-related. The 1940 Act requires that we and each of our subsidiaries evaluate our qualification for exemption under the Act. Our subsidiaries will rely either on Section 3(c)(5)(C) or other sections that provide exemptions from registering under the 1940 Act, including Sections 3(a)(1)(C) and 3(c)(7). The SEC is currently reviewing the Section 3(c)(5)(C) exemption as further discussed below. We believe that we are operating our business in accordance with the exemption requirements of Section 3(c)(5)(C).

Under the 1940 Act, an investment company is required to register with the SEC and is subject to extensive restrictive and potentially adverse regulations relating to, among other things, operating methods, management, capital structure, dividends, and transactions with affiliates. If we were determined to be an investment company, our ability to use leverage and conduct business as we do today would be substantially impaired.

***In August 2011, the SEC initiated a review of Section 3(c)(5)(C) of the 1940 Act and the regulations and regulatory interpretations promulgated thereunder. We rely on Section 3(c)(5)(C) as an exemption from registration and regulation under the 1940 Act and any regulatory changes as a result of this SEC review could require us to change our business and operations.***

On August 31, 2011, the SEC issued a concept release relating to the exclusion from registration as an investment company provided to mortgage companies by Section 3(c)(5)(C) of the 1940 Act. This release raises concerns regarding the ability of mortgage REITs to continue to rely on the exclusion in the future. In particular, the release states the SEC is concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies such as closed-end funds and may not be the kinds of companies that were intended to be excluded from regulation under the 1940 Act by Section 3(c)(5)(C).

Although we believe that we are properly relying on Section 3(c)(5)(C) to exempt us from regulation under the 1940 Act (which belief in large part is based on no-action letters issued by the SEC with respect to operations of other mortgage REITs), the SEC review could eventually affect our ability to rely on that exemption or could eventually require us to change our business and operations in order for us to continue to rely on that exemption. If the SEC changes or narrows this exemption, we could be required to sell a substantial amount of our MBS under potentially adverse market conditions, which could have a material adverse effect on our financial condition and results of operations. We could also be forced to materially alter our business model and investment strategies which could materially and adversely affect our profitability.

The outcome of the review by the SEC at this time is not determinable, and the SEC may take no action as a result of its review of the Section 3(c)(5)(C) exemption from the 1940 Act. It is also possible that the SEC issues interpretative guidance for mortgage REITs as to how their operations must be structured in order to avoid being considered an investment company, and compliance with any such guidance could limit our operations and our profitability as indicated above. Finally, it is possible that the SEC requires mortgage REITs to be considered investment companies and to register under the 1940 Act which would severely limit our operations and profitability and likely have a material adverse effect on our financial condition and results of operations.

#### **Other Regulatory Risks**

***In the event of bankruptcy either by ourselves or one or more of our third party lenders, under the U.S. Bankruptcy Code, assets pledged as collateral under repurchase agreements may not be recoverable by us. We may incur losses equal to the excess of the collateral pledged over the amount of the associated repurchase agreement borrowing.***

In the event that one of our lenders under a repurchase agreement files for bankruptcy, it may be difficult for us to recover our assets pledged as collateral to such lender. In addition, if we ever file for bankruptcy, lenders under our repurchase agreements may be able to avoid the automatic stay provisions of the U.S. Bankruptcy Code and take possession of and liquidate our collateral under our repurchase agreements without delay. In the event of a bankruptcy by one of our lenders, or us, we may incur losses in amounts equal to the excess of our collateral pledged over the amount of repurchase agreement borrowing due to the lender.

***If we fail to abide by certain Commodity Futures Trading Commission ("CFTC") rules and regulations, we may be subject enforcement action by the CFTC.***

On December 7, 2012, the CFTC's Division of Swap Dealer and Intermediary Oversight (the "Division") issued no-action relief from commodity pool operator ("CPO") registration to mortgage REITs that use CFTC-regulated products ("commodity interests") and that satisfy certain enumerated criteria. Pursuant to such no-action letter, the Division will not recommend that the CFTC take enforcement action against a mortgage REIT if its operator fails to register as a CPO, provided that the mortgage REIT (i) submits a claim to take advantage of the relief and (ii) the mortgage REIT: (a) limits the initial margin and premiums required to establish its commodity interest positions to no greater than 5 percent of the fair market value of the mortgage REIT's total assets; (b) limits the net income derived annually from its commodity interest positions, excluding the income from commodity interest positions that are "qualifying hedging transactions," to less than 5 percent of its annual gross income; (c) does not market interests in the mortgage REIT to the public as interests in a commodity pool or otherwise in a vehicle for trading in the commodity futures, commodity options or swaps markets; and (d) either: (A) identified itself as a "mortgage REIT" in Item G of its last U.S. income tax return on Form 1120-REIT; or (B) if it has not yet filed its first U.S. income tax return on Form 1120-REIT, it discloses to its shareholders that it intends to identify itself as a "mortgage REIT" in its first U.S. income tax return on Form 1120-REIT.

We submitted our claim to the Division on December 19, 2012 and intend to satisfy the criteria set forth above. If we do not satisfy the criteria set forth above, we may become subject to CFTC regulation or enforcement action, the consequences of which could have a material adverse effect on our financial condition or results of operations.

#### **Risks Related to Accounting and Reporting Requirements**

*Estimates are inherent in the process of applying GAAP, and management may not always be able to make estimates which accurately reflect actual results, which may lead to adverse changes in our reported GAAP results.*

Interest income on our assets and interest expense on our liabilities is partially based on estimates of future events. These estimates can change in a manner that negatively impacts our results or can demonstrate, in retrospect, that revenue recognition in prior periods was too high or too low. For example, we use the effective yield method of accounting for many of our investments which involves calculating projected cash flows for each of our assets. Calculating projected cash flows involves making assumptions about the amount and timing of credit losses, loan prepayment rates, and other factors. The yield we recognize for GAAP purposes generally equals the discount rate that produces a net present value for actual and projected cash flows that equals our GAAP basis in that asset. We update the yield recognized on these assets based on actual performance and as we change our estimates of future cash flows. The assumptions that underlie our projected cash flows and effective yield analysis may prove to be overly optimistic, or conversely, overly conservative. In these cases, our GAAP yield on the asset or cost of the liability may change, leading to changes in our reported GAAP results.

#### **Risks Related to Owning Our Stock**

*The stock ownership limit imposed by the Code for REITs and our Articles of Incorporation may restrict our business combination opportunities. The stock ownership limitation may also result in reduced liquidity in our stock and may result in losses to an acquiring shareholder.*

To qualify as a REIT under the Code, not more than 50% in value of our outstanding stock may be owned, directly or indirectly, by five or fewer individuals (as defined in the Code to include certain entities) at any time during the last half of each taxable year after our first year in which we qualify as a REIT. Our Articles of Incorporation, with certain exceptions, authorize our Board of Directors to take the actions that are necessary and desirable to qualify as a REIT. Pursuant to our Articles of Incorporation, no person may beneficially or constructively own more than 9.8% of our capital stock (including our common stock, Series A Preferred Stock, and Series B Preferred Stock). Our Board of Directors may grant an exemption from this 9.8% stock ownership limitation, in its sole discretion, subject to such conditions, representations and undertakings as it may determine are reasonably necessary.

The ownership limits imposed by the tax law are based upon direct or indirect ownership by "individuals," but only during the last half of a tax year. The ownership limits contained in our Articles of Incorporation apply to the ownership at any time by any "person," which includes entities, and are intended to assist us in complying with the tax law requirements and to minimize



administrative burdens. However, these ownership limits might also delay or prevent a transaction or a change in our control that might involve a premium price for our stock or otherwise be in the best interest of our shareholders.

Whether we would waive the ownership limitation for any other shareholder will be determined by our Board of Directors on a case by case basis. Our Articles of Incorporation's 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 less than these percentages of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of these percentages of the outstanding stock and thus be subject to the ownership limit. The Board of Directors has the right to refuse to transfer any shares of our capital stock in a transaction that would result in ownership in excess of the ownership limit. In addition, we have the right to redeem shares of our capital stock held in excess of the ownership limit.

***The stock ownership limit imposed by the Code for REITs and our Articles of Incorporation may impair the ability of holders to convert shares of our Series A Preferred Stock or Series B Preferred Stock into shares of our common stock upon a change of control.***

The terms of our Series A Preferred Stock and Series B Preferred Stock provide that, upon occurrence of a change of control (as defined in the Articles of Incorporation), each holder of Series A Preferred Stock or Series B Preferred Stock will have the right (unless, prior to the Change of Control Conversion Date (as defined herein), we provide notice of our election to redeem the Series A Preferred Stock or Series B Preferred Stock, as applicable) to convert all or part of the Series A Preferred Stock and Series B Preferred Stock held by such holder on the Change of Control Conversion Date into a number of shares of our common stock per share of Series A Preferred Stock or Series B Preferred Stock, respectively, based on formulas set forth in our Articles of Incorporation. However, the stock ownership restrictions in our Articles of Incorporation also restrict ownership of shares of our Series A Preferred Stock and Series B Preferred Stock. As a result, no holder of Series A Preferred Stock or Series B Preferred Stock will be entitled to convert such stock into our common stock to the extent that receipt of our common stock would cause the holder to exceed the ownership limitations contained in our Articles of Incorporation, endanger the tax status of one or more real estate mortgage investment conduits ("REMICs") in which we have or plan to have an interest, or result in the imposition of a direct or indirect penalty tax on us. These provisions may limit the ability of a holder of Series A Preferred Stock or Series B Preferred Stock to convert shares of Series A Preferred Stock or Series B Preferred Stock into our common stock upon a change of control, which could adversely affect the market price of shares of our Series A Preferred Stock or of our Series B Preferred Stock.

***Dividends payable by REITs do not qualify for the reduced tax rates available for some dividends.***

The maximum tax rate applicable to income from "qualified dividends" payable to domestic shareholders that are individuals, trusts and estates may be either 15% or 20%, depending on whether the taxpayer's income exceeds the threshold for the newly enacted 39.6% income tax bracket. Dividends payable by REITs, however, generally are not eligible for the reduced rates. Although this legislation does not adversely affect the taxation of REITs or dividends payable by REITs, the more favorable rates applicable to regular corporate qualified dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock.

***Recognition of excess inclusion income by us could have adverse consequences to us or our shareholders.***

Certain of our securities have historically generated excess inclusion income and may continue to do so in the future. Certain categories of shareholders, such as foreign shareholders eligible for treaty or other benefits, shareholders with NOLs, and certain tax-exempt shareholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income from us that is attributable to excess inclusion income. In addition, to the extent that our stock is owned by tax-exempt "disqualified organizations," such as certain government-related entities and charitable remainder trusts that are not subject to tax on unrelated business income, we may incur a corporate level tax on a portion of our income. In that case, we may reduce the amount of our distributions to any disqualified organization whose stock ownership gave rise to the tax.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

There are no unresolved comments from the SEC Staff.

## **ITEM 2. PROPERTIES**

We lease one facility located at 4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia 23060 under two separate leases which provides a total of 9,280 square feet of office space for our executive officers and administrative staff. The term of the first lease for 7,068 square feet expires in March 2014, but may be renewed at our option for one additional five-year period at a rental rate 3% greater than the rate in effect during the preceding 12-month period. The term of the second lease for 2,212 square feet expires in January 2017 and is not subject to a renewal option. We are currently negotiating a consolidation of the leases with the landlord into a single lease expiring in March 2020 and expect to enter into a new lease agreement before the expiration of the lease on 7,068 square feet in March 2014. We believe that our property is maintained in good operating condition and is suitable and adequate for our purposes.

## **ITEM 3. LEGAL PROCEEDINGS**

The Company and its subsidiaries are parties to various legal proceedings, including those described below. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings will not have a material adverse effect on the Company's consolidated financial condition or liquidity. However, the resolution of any of the proceedings described below could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

One of the Company's subsidiaries, GLS Capital, Inc. ("GLS"), the County of Allegheny, Pennsylvania ("Allegheny County"), and the Company are named defendants in a putative class action lawsuit filed in June 2012 in the Court of Common Pleas of Allegheny County, Pennsylvania (the "Court"). Between 1995 and 1997, GLS purchased from Allegheny County delinquent property tax lien receivables for properties located in the county. The purported class in this action consists of owners of real estate in Allegheny County whose property is or has been subject to a tax lien filed by Allegheny County that Allegheny County either retained or sold to GLS and who were billed by Allegheny County or GLS for attorneys' fees, interest, and certain other fees and who sustained economic damages on and after August 14, 2003. The putative class allegations are that Allegheny County, GLS, and the Company violated the class's constitutional due process rights in connection with delinquent tax collection efforts. There are also allegations that amounts recovered from the class by GLS and / or Allegheny County are an unconstitutional taking of private property. The claims against the Company are solely based upon its ownership of GLS. The complaint requests that the Court order GLS to account for amounts alleged to have been collected in violation of the putative class members' rights and create a constructive trust for the return of such amounts to members of the purported class. The Company believes the claims are without merit and intends to defend against them vigorously in this matter. The same class previously filed substantially the same lawsuit in 2004 against GLS and Allegheny County (ACORN v. County of Allegheny and GLS Capital, Inc.), and that case was dismissed by the Court with prejudice on June 28, 2013.

The Company and DCI Commercial, Inc. ("DCI"), a former affiliate of the Company and formerly known as Dynex Commercial, Inc., are appellees (or respondents) in the matter of Basic Capital Management, Inc. et al. (collectively, "BCM" or the "Plaintiffs") versus DCI et al. currently pending in state court in Dallas, Texas. The matter was initially filed in the state court in Dallas County, Texas in April 1999 against DCI, and in March 2000, BCM amended the complaint and added the Company as a defendant. Following a trial court decision in favor of both the Company and DCI, Plaintiffs appealed, seeking reversal of the trial court's judgment and rendition of judgment against the Company for alleged breach of loan agreements for tenant improvements in the amount of \$0.3 million. Plaintiffs also sought reversal of the trial court's judgment and rendition of judgment against DCI in favor of BCM under two mutually exclusive damage models, for \$2.2 million and \$25.6 million, respectively, related to the alleged breach by DCI of a \$160 million "master" loan commitment. Plaintiffs also sought reversal and rendition of a judgment in their favor for attorneys' fees in the amount of \$2.1 million. Alternatively, Plaintiffs sought a new trial. On February 13, 2013, the Fifth Circuit Court of Appeals in Dallas, Texas (the "Fifth Circuit") ruled on Plaintiffs' appeal, affirming the previous decision of no liability with respect to the Company, and reversing the previous decision of no liability with respect to DCI relating to the \$160 million "master" loan commitment. The Fifth Circuit ordered a new trial to determine the amount of attorneys' fees and

prejudgment and post-judgment interest due to Plaintiffs and reinstated the \$25.6 million damage award against DCI. On May 22, 2013, the Fifth Circuit vacated its order on February 13, 2013 and remanded the case to the trial court for entry of judgment against DCI and for a new trial with respect to attorneys' fees and for costs and pre-judgment and post-judgment interest as determined by the trial court. The Fifth Circuit also affirmed the trial court's decision with respect to a take nothing judgment against the Company. DCI has appealed the matter to the Supreme Court of Texas to reverse the \$25.6 million damage award. Management believes the Company will not be obligated for any amounts that may ultimately be awarded against DCI.

#### **ITEM 4. MINE SAFETY DISCLOSURES**

None.

## PART II.

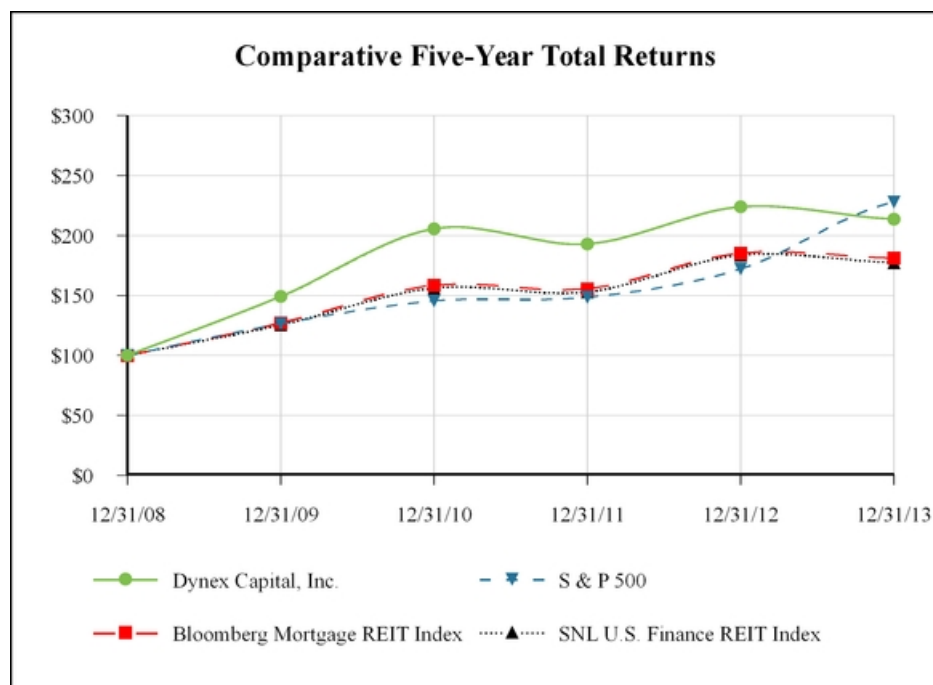
### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the New York Stock Exchange under the trading symbol “DX”. The common stock was held by approximately 24,421 holders of record as of February 28, 2014. On that date, the closing price of our common stock on the New York Stock Exchange was \$8.55 per share. The high and low stock prices and cash dividends declared on our common stock, our Series A Preferred Stock, and our Series B Preferred Stock for each quarter during the last two years were as follows:

	High	Low	Common Stock Dividends Declared	Series A Preferred Stock	Series B Preferred Stock
<b>2013:</b>					
First quarter	\$11.06	\$9.53	\$0.27	\$0.53125	\$—
Second quarter	\$11.00	\$9.79	\$0.27	\$0.53125	\$0.46068
Third quarter	\$10.25	\$7.71	\$0.29	\$0.53125	\$0.47656
Fourth quarter	\$9.00	\$7.91	\$0.29	\$0.53125	\$0.47656
<b>2012:</b>					
First quarter	\$9.64	\$9.04	\$0.28	\$—	\$—
Second quarter	\$10.49	\$8.94	\$0.29	\$—	\$—
Third quarter	\$10.98	\$9.92	\$0.29	\$0.43875	\$—
Fourth quarter	\$10.90	\$8.66	\$0.29	\$0.53125	\$—

Any dividends declared by the Board of Directors have generally been for the purpose of maintaining our REIT status and maintaining compliance with dividend requirements of the Series A Preferred Stock and Series B Preferred Stock.

The following graph is a five year comparison of cumulative total returns for the shares of our common stock, the Standard & Poor’s 500 Stock Index (“S&P 500”), the Bloomberg Mortgage REIT Index, and the SNL U.S. Finance REIT Index. The table below assumes \$100 was invested at the close of trading on December 31, 2008 in each of our common stock, the S&P 500, the Bloomberg Mortgage REIT Index, and the SNL U.S. Finance REIT Index and assumes reinvestment of dividends.



Index	Cumulative Total Stockholder Returns as of December 31,					
	2008	2009	2010	2011	2012	2013
Dynex Capital, Inc. Common Stock	\$ 100.00	\$ 149.16	\$ 205.56	\$ 193.09	\$ 223.87	\$ 213.80
S&P 500	\$ 100.00	\$ 126.47	\$ 145.52	\$ 148.60	\$ 172.21	\$ 227.97
Bloomberg Mortgage REIT Index	\$ 100.00	\$ 127.10	\$ 158.61	\$ 155.68	\$ 185.36	\$ 181.13
SNL U.S. Finance REIT Index	\$ 100.00	\$ 125.37	\$ 156.06	\$ 152.88	\$ 183.60	\$ 177.32

The sources of this information are Bloomberg, SNL Financial, and Standard & Poor's, which management believes to be reliable sources. The historical information set forth above is not necessarily indicative of future performance. Accordingly, we do not make or endorse any predictions as to future share performance.

We may purchase up to \$50 million of our outstanding shares of common stock through December 31, 2014 as authorized by our Board of Directors. Subject to applicable securities laws and the terms of the Series A Preferred Stock and the Series B Preferred Stock designations, which are contained in our Articles of Incorporation, future repurchases of common stock will be made at times and in amounts as management deems appropriate, provided that the repurchase price per share is less than management's estimate of the current net book value of a share of common stock. Repurchases may be suspended or discontinued at any time. The following table provides common stock repurchases made by us or on our behalf during the quarter ending December 31, 2013:

	Total Number of Shares Purchased	Average Price Paid Per Share <sup>(1)</sup>	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Approximate Dollar Value of Shares that May Yet Be Purchased under the Plans or Programs
				(\$ in thousands)
October 1, 2013 - October 31, 2013	—	\$ —	—	\$ 43,115
November 1, 2013 - November 30, 2013	—	—	—	43,115
December 1, 2013 - December 31, 2013	120,991	8.01	120,991	42,145
	120,991	\$ 8.01	120,991	\$ 42,145

(1) Average price per share includes broker commissions paid in connection with common stock repurchases.

## ITEM 6. SELECTED FINANCIAL DATA

Our selected financial data presented below is derived from our audited financial statements and should be read in conjunction with our consolidated financial statements and the accompanying notes included under Item 8 of this Annual Report on Form 10-K.

### Non-GAAP Financial Measures

In addition to our operating results presented in accordance with GAAP, the information presented below and within Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report on Form 10-K contains the following non-GAAP financial measures: core net operating income to common shareholders (including per common share), effective borrowing costs and rates, adjusted net interest income, adjusted net interest spread, and adjusted return on average common equity. Management uses these non-GAAP financial measures in its internal analysis of results and operating performance and believes these measures may be important to investors and present useful information about the Company's performance. We are presenting these non-GAAP financial measures as a result of discontinuing cash flow hedge accounting effective June 30, 2013.

Core net operating income to common shareholders equals GAAP net income to common shareholders adjusted for amortization of accumulated other comprehensive loss on de-designated interest rate swaps included in GAAP interest expense, net change in fair value of derivative instruments, gains and losses on terminated derivative instruments, gains and losses on sales of investments, litigation settlement and related costs, loss on non-recourse collateralized financing, and fair value adjustments on investments not classified as available for sale. Effective borrowing costs equals GAAP interest expense excluding the amortization of accumulated other comprehensive loss on interest rate swaps de-designated as cash flow hedges on June 30, 2013 plus net periodic interest costs of derivative instruments (including accrued amounts) which are not already included in GAAP interest expense. Effective borrowing rate equals annualized cost of funds calculated on a GAAP basis, less the effect of amortization of de-designated cash flow hedges and plus the effect of net periodic interest costs of derivative instruments. Adjusted net interest income equals GAAP net interest income less effective borrowing costs. Adjusted net interest spread equals average annualized yields on investments less effective borrowing rates. Adjusted return on average common equity equals core net operating income divided by average common equity during the period. Schedules reconciling these non-GAAP financial measures to GAAP financial measures are provided below.

Management believes these non-GAAP financial measures are useful because they provide investors greater transparency to the information we use in our financial and operational decision-making processes. Management also believes the presentation of these measures, when analyzed in conjunction with the our GAAP operating results, allows investors to more effectively evaluate and compare our performance to that of our peers, particularly those competitors that continue to use hedge accounting in reporting their financial results, as well as to our performance in periods prior to discontinuing cash flow hedge accounting. As an investor

in MBS on a leveraged basis, we believe adjusted net interest income and adjusted net interest spread is an important indicator of the profitability of our investment strategy because it includes cash flow hedging costs that are not included in the related GAAP presentation. Because these non-GAAP financial measures exclude certain items used to compute GAAP net income to common shareholders and GAAP interest expense, these non-GAAP measures should be considered as a supplement to, and not as a substitute for, our GAAP results as reported in our consolidated statements of net income (loss). In addition, because not all companies use identical calculations, our presentation of core net operating income, effective borrowing costs and rates, adjusted net interest income, adjusted net interest spread, and adjusted return on average common equity may not be comparable to other similarly-titled measures of other companies.

	As Of/For the Year Ended December 31,					
	2013	2012	2011	2010	2009	
<b>Balance Sheet Data:</b>	<i>(amounts in thousands except share and per share data)</i>					
Investments	\$ 4,073,584	\$ 4,175,662	\$ 2,500,976	\$ 1,614,126	\$ 914,421	
Total assets	4,217,137	4,280,229	2,582,193	1,649,584	958,062	
Repurchase agreements	3,580,754	3,564,128	2,093,793	1,234,183	638,329	
Non-recourse collateralized financing	12,914	30,504	70,895	107,105	143,081	
Total liabilities	3,631,261	3,663,519	2,210,844	1,357,227	789,309	
Shareholders' equity	585,876	616,710	371,349	292,357	168,753	
Common shares outstanding	54,310,484	54,268,915	40,382,530	30,342,897	13,931,512	
Book value per common share <sup>(1)</sup>	\$ 8.69	\$ 10.30	\$ 9.20	\$ 9.64	\$ 9.08	
<b>Income Statement Data:</b>						
Interest income	\$ 127,132	\$ 113,548	\$ 83,377	\$ 48,781	\$ 39,236	
Interest expense	39,028	35,147	24,082	14,357	14,678	
Net interest income	88,104	78,401	59,295	34,424	24,558	
Loss on derivative instruments, net <sup>(2)</sup>	(10,076)	(908)	(2,825)	—	—	
Gain on sale of investments, net	3,354	8,461	2,096	2,891	171	
General and administrative expenses	(13,058)	(12,736)	(9,956)	(8,817)	(6,716)	
Net income to common shareholders	60,167	72,006	39,812	26,411	13,571	
Net income per common share:						
Basic	\$ 1.10	\$ 1.35	\$ 1.03	\$ 1.50	\$ 1.04	
Diluted	\$ 1.10	\$ 1.35	\$ 1.03	\$ 1.41	\$ 1.02	
Dividends declared per share:						
Common	\$ 1.12	\$ 1.15	\$ 1.09	\$ 0.98	\$ 0.92	
Series A Preferred	\$ 2.13	\$ 0.97	\$ —	\$ —	\$ —	
Series B Preferred	\$ 0.94	\$ —	\$ —	\$ —	\$ —	
Series D Preferred	\$ —	\$ —	\$ —	\$ 0.71	\$ 0.95	

(1) The calculation of book value per common share as of December 31, 2013, December 31, 2012, and December 31, 2009 excludes the aggregate liquidation value of the preferred stock outstanding as of those dates which was \$113.8 million, \$57.5 million, and \$43.2 million, respectively.

(2) Loss on derivative instruments, net increased significantly during the year ended December 31, 2013 due to our discontinuation of cash flow hedge accounting for our interest rate derivative instruments effective June 30, 2013. Please refer to Note 1 within our Notes to the Consolidated Financial Statements for additional information.

**For the Year Ended December 31,**

	2013	2012	2011	2010	2009
<b>Other Data Including Non-GAAP Financial Measures:</b>	<i>(\$ in thousands except per share data)</i>				
Effective borrowing costs <sup>(1)</sup>	\$ 42,783	\$ 35,801	\$ 24,680	\$ 14,357	\$ 14,678
Adjusted net interest income <sup>(1)</sup>	84,349	77,747	58,697	34,424	24,558
Core net operating income to common shareholders <sup>(1)</sup>	63,786	63,064	50,829	22,665	13,195
Core net operating income per common share <sup>(1)</sup>	\$ 1.17	\$ 1.19	\$ 1.32	\$ 1.29	\$ 1.01
Average common equity during the period	\$ 522,432	\$ 521,200	\$ 361,212	\$ 169,660	\$ 155,943
ROAE, calculated using GAAP net income	11.5%	13.8%	11.0%	15.6%	8.7%
Adjusted ROAE, calculated using core net operating income <sup>(1)</sup>	12.2%	12.1%	14.1%	13.4%	8.5%
Average interest earning assets	\$ 4,290,073	\$ 3,492,158	\$ 2,283,440	\$ 1,012,520	\$ 740,640
Average balance of borrowings	3,797,845	3,069,348	2,002,981	865,920	627,848
Effective yield earned on assets <sup>(2)</sup>	2.96%	3.25%	3.64%	4.81%	5.29%
Annualized cost of funds <sup>(3)</sup>	1.01%	1.12%	1.19%	1.64%	2.06%
Net interest spread	1.95%	2.13%	2.45%	3.17%	3.23%
Effective borrowing rate <sup>(1)</sup>	1.10%	1.14%	1.22%	1.64%	2.06%
Adjusted net interest spread <sup>(4)</sup>	1.86%	2.11%	2.42%	3.17%	3.23%

(1) Represents a non-GAAP financial measure. See reconciliations provided below.

(2) Effective yields are based on annualized amounts. Recalculation of effective yields may not be possible using data provided because certain components of interest income use a 360-day year for the calculation while others use actual number of days in the year.

(3) Rates shown are based on annualized interest expense amounts divided by average balance of borrowings. Recalculation of annualized cost of funds using total interest expense shown in the table may not be possible because certain expense items use a 360-day year for the calculation while others use actual number of days in the year.

(4) Adjusted net interest spread is a non-GAAP financial measure and is equal to effective yield earned on assets less the effective borrowing rate, both of which are included in the table above.



For the Year Ended December 31,					
	2013	2012	2011	2010	2009
<b>Reconciliations of GAAP to Non-GAAP Financial Measures:</b>					
	<i>(amounts in thousands except share and per share data)</i>				
GAAP net income to common shareholders	\$ 60,167	\$ 72,006	\$ 39,812	\$ 26,411	\$ 13,571
Amortization of de-designated cash flow hedges <sup>(1)</sup>	5,193	—	—	—	—
Change in fair value on derivative instruments, net <sup>(2)</sup>	1,128	254	2,227	—	—
Litigation settlement and related costs	—	—	8,240	—	—
Loss on non-recourse collateralized financing	—	—	1,970	—	—
Gain on sale of investments, net	(3,354)	(8,461)	(2,096)	(3,452)	(171)
Fair value adjustments, net	652	(735)	676	(294)	(205)
Core net operating income to common shareholders	\$ 63,786	\$ 63,064	\$ 50,829	\$ 22,665	\$ 13,195
Average common shares outstanding	54,647,643	53,146,416	38,579,780	17,595,022	13,088,154
Core net operating income per common share	\$ 1.17	\$ 1.19	\$ 1.32	\$ 1.29	\$ 1.01
GAAP interest expense	\$ 39,028	\$ 35,147	\$ 24,082	\$ 14,357	\$ 14,678
Amortization of de-designated cash flow hedges <sup>(1)</sup>	(5,193)	—	—	—	—
Net periodic interest costs of derivative instruments <sup>(3)</sup>	8,948	654	598	—	—
Effective borrowing costs	\$ 42,783	\$ 35,801	\$ 24,680	\$ 14,357	\$ 14,678
GAAP annualized cost of funds <sup>(4)</sup>	1.01 %	1.12%	1.19%	1.64%	2.06%
Effect of amortization of de-designated cash flow hedges <sup>(1)</sup>	(0.15)%	—%	—%	—%	—%
Effect of net periodic interest costs of derivative instruments <sup>(3)</sup>	0.24 %	0.02%	0.03%	—%	—%
Effective borrowing rate <sup>(4)</sup>	1.10 %	1.14%	1.22%	1.64%	2.06%
GAAP interest income	\$ 127,132	\$ 113,548	\$ 83,377	\$ 48,781	\$ 39,236
Effective borrowing costs	42,783	35,801	24,680	14,357	14,678
Adjusted net interest income	\$ 84,349	\$ 77,747	\$ 58,697	\$ 34,424	\$ 24,558

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of the Company's discontinuation of cash flow hedge accounting.

(2) Represents net realized and unrealized gains and losses on derivatives and excludes net periodic interest costs made on these instruments.

(3) Net periodic interest costs of derivative instruments equals the net interest payments (including accrued amounts) related to interest rate derivatives during the period which are recorded in "loss on derivative instruments, net" and not already included in "interest expense" in accordance with GAAP.

(4) Rates shown are based on annualized interest expense amounts. Recalculation of annualized cost of funds and effective borrowing rates using interest expense shown in the table may not be possible because certain items use a 360-day year for the calculation while others use actual number of days in the year.

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

The following discussion should be read in conjunction with our financial statements and the related notes included in Item 8. "Financial Statements and Supplementary Data" in this Annual Report on Form 10-K. This discussion is presented in five sections:

- [Executive Overview](#)
- [Financial Condition](#)
- [Results of Operations](#)
- [Liquidity and Capital Resources](#)
- [Forward-Looking Statements](#)

This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors including, but not limited to, those disclosed in Item 1A. "Risk Factors" elsewhere in this Annual Report on Form 10-K and in other documents filed with the SEC and otherwise publicly disclosed. Please refer to "Forward-Looking Statements" contained within this Item 7 for additional information.

This discussion also contains non-GAAP financial measures. Please refer to Item 6 of this Annual Report on Form 10-K for reconciliations of these non-GAAP measures and additional information about why management believes these non-GAAP measures are useful for shareholders.

### EXECUTIVE OVERVIEW

Please refer to Item 1 of Part 1 of this Annual Report on Form 10-K for a complete description of our business including our operating policies, investment philosophy and strategy, financing and hedging strategies, and other important information.

#### Highlights for the Fiscal Year and the Fourth Quarter of 2013

During 2013, fixed income markets experienced periods of high volatility as a result of large fluctuations in interest rates during the year. At the beginning of 2013, the two-year and ten-year Treasury rates were 0.25% and 1.76%, respectively; these rates touched a low of 0.20% and 1.63%, respectively, and ended the year at 0.38% and 3.03%, respectively. Most of the volatility can be attributed to the changes in market expectations with respect to Federal Reserve purchases of assets under its Large Scale Asset Purchase (LSAP) program (discussed further below). Despite the volatility, we continued to focus on our strategy of investing in high quality, shorter duration Agency and non-Agency RMBS and CMBS. While we experienced a decline in our book value per common share as a result of declines in the market value of our MBS during the year, we generated a return on common equity of 11.5% based on net income to common shareholders of \$60.2 million, and an adjusted return on common equity of 12.2% based on core net operating income to common shareholders of \$63.8 million. Our net interest income increased by 12% in 2013 due primarily to a larger interest earning asset base and lower borrowing costs, partially offset by lower weighted average yields on our investment assets. Overall, our net interest spread for 2013 was 1.95% versus 2.13% for 2012, reflecting the lower weighted average yields from investments made in 2013.

Management believes the events contributing to the market volatility included market reaction to the the Federal Reserve reducing its bond purchases under its LSAP program (also referred to as "QE3") which triggered global de-risking in virtually all asset classes. In 2013 the Federal Reserve reduced its LSAP program by \$10 billion per month which it has continued so far in 2014. We believe that economic fundamentals are uncertain and that the U.S. economy cannot withstand sustained higher interest rates. As a result, we anticipate that the Federal Reserve will continue to keep the targeted federal funds rate very low for an extended period as discussed further below in "Trends and Recent Market Impacts". We believe that the Federal Reserve will continue its reductions in its QE3 bond purchase program in 2014 which may result in periods of volatility in asset prices as interest rates rise and credit market spreads adjust to the reduced purchases by the Federal Reserve (which has dominated the purchases of fixed rate Agency MBS and Treasury securities since the inception of QE3).

During the fourth quarter of 2013, we were selective in making investments given the environment. We also repositioned our hedging instruments and increased our modeled duration gap (a measure of the sensitivity of our investments and derivative instruments to changes in interest rates) during the quarter, which ended 2013 at the higher end of our 0.5-1.5 years target range. Our investments and derivative instruments are most sensitive to changes in rates on one-to-three year maturities, as compared to further out the yield curve. One-to-three year rates are generally more sensitive to changes in the targeted federal funds rate. Finally we began extending repurchase agreement maturities (in particular in terms greater than 120 days) given the declining cost and greater availability of longer-term borrowing.

During 2013 we continued to make investments in CMBS and CMBS IO. The CMBS market has rebounded since 2008 with better underwriting, more credit enhancement supporting our investment, and broader investor participation. We believe that fundamentals are still positive in commercial real estate, particularly multifamily, given demographic fundamentals and attitude shifts. In addition, multifamily trends are supported by declining vacancies and increasing rents.

Effective June 30, 2013, we voluntarily discontinued hedge accounting for all interest rate swaps which we previously designated as cash flow hedges under GAAP. This decision to discontinue cash flow hedge accounting was made to facilitate our ability to more effectively manage the maturity dates of our repurchase agreements. Changes in the fair value of interest rate swaps and other derivative instruments are reported in our consolidated statements of net income as "loss on derivative instruments, net" and are no longer be reported in shareholders' equity through accumulated other comprehensive income (loss).

#### **Trends and Recent Market Impacts**

There are certain conditions and prospective trends in the marketplace that have impacted our current financial condition and results of operations and which may continue to impact us in the future. The following provides a discussion of conditions and trends that had significant developments during 2013 or are new conditions and trends that are important to our financial condition and results of operations.

##### *Federal Reserve Monetary Policy*

The Federal Open Market Committee ("FOMC") continues its purchase of U.S. Treasury and fixed-rate Agency MBS under its asset purchase program known as "QE3". The FOMC as of the date of this Annual Report on Form 10-K is purchasing \$65 billion per month in securities down from a high of \$85 billion per month in 2013. The FOMC has reduced its purchases of Treasury and Agency MBS as a result of perceived improvements in the underlying strength of the broader economy as evidenced by continued improvement in economic activity and labor market conditions. The FOMC has reiterated its commitment to maintaining a highly accommodative stance of monetary policy for a considerable time after the QE3 asset purchase program ends and the economic recovery strengthens. The FOMC has pledged to keep the target range for the federal funds rate at 0%-0.25% and indicated that it anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the FOMC's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the FOMC stated that it will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. Market participants are currently forecasting an end to asset purchases by the FOMC in 2014 and an increase in the targeted federal funds rate sometime in the second quarter of 2015.

### Asset Spreads and Competition for Assets

Over the past several years, credit markets in the United States have generally experienced tightening credit spreads (where credit spreads are defined as the difference between yields on securities with credit risk and yields on benchmark securities and that reflects the relative riskiness of the securities versus the benchmark). Changes in credit spreads result from the expansion or contraction of the perceived riskiness of an investment versus its benchmark. Spreads on MBS had tightened throughout the first half of 2013 from increased competition for these assets due to lack of supply, favorable market conditions in large part due to the Federal Reserve's involvement in the markets, and substantial amounts of capital raised by mortgage REITs and other market participants. Reductions in credit spreads resulted in an increase in asset prices which increased our book value. During the second half of 2013, credit spreads widened on MBS due to the Federal Reserve's actions with respect to QE3 (discussed above), expectations that interest rates would be increasing for the foreseeable future, and the overall lack of liquidity in the markets. The following table provides various estimated market credit spreads on categories of assets owned by the Company as well as other market credit spreads as of the end of each quarter in 2013:

<i>(amounts in basis points)</i>	<b>December 31, 2013</b>	<b>September 30, 2013</b>	<b>June 30, 2013</b>	<b>March 31, 2013</b>
Hybrid ARM 5/1 (2.0% coupon) spread to Treasuries	30	40	45	18
Hybrid ARM 10/1 (2.5% coupon) spread to Treasuries	76	80	75	34
Agency CMBS spread to interest rate swaps	58	72	92	59
'A'-rated CMBS spread to interest rate swaps	220	255	287	205
Agency CMBS IO spread to Treasuries	165	200	200	115

As noted in the table above, market credit spreads widened dramatically in the second quarter of 2013. Market credit spreads decreased over the balance of the year, but ended the year wider than in the first quarter of 2013. Most of the spread widening occurred at the same time interest rates were rapidly rising after comments by Federal Reserve officials regarding the possible reduction in its QE3 purchase program. Spread widening negatively impacted our book value from declining fair values on our MBS but provided us an opportunity to acquire assets at higher yields. Spreads have continued to tighten into 2014.

### GSE Reform

Policy makers in Washington DC continue to debate the future of Fannie Mae and Freddie Mac's participation in the U.S. mortgage market. Several bills have been introduced in the U.S. Senate and the U.S. House of Representatives regarding the reform and/or dissolution of the GSEs. Any changes to the structure of the GSEs, or the revocations of their charters, if enacted, may have broad adverse implications for the MBS market and our business, results of operations, and financial condition. We expect such proposals to be the subject of significant discussion, and it is not yet possible to determine whether such proposals will be enacted. While we expect GSE reform to be a multi-year process, it is possible that new types of Agency MBS could be proposed and sold by Fannie Mae and Freddie Mac in the near term that are structured differently from current Agency MBS. This may have the effect of reducing the amount of available investment opportunities for the Company. For further discussion of the uncertainties and risks related to GSE reform, please refer to "Risk Factors" contained within Part I, Item 1A of this Annual Report on Form 10-K.

### Regulatory Uncertainty

Certain rules recently adopted or proposed by regulators of financial institutions require such financial institutions to maintain minimum amounts of capital relative to its assets. One such proposal was made in June 2013 by the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency to strengthen the leverage ratio standards for the largest, most systemically significant U.S. banking organizations defined as bank holding companies with more than \$700 billion in consolidated total assets or \$10 trillion in assets under custody. Under the proposal, these entities would be required to maintain a tier 1 capital leverage buffer of at least 2 percent above the minimum supplementary leverage ratio requirement of 3 percent, for a total of 5 percent. Such amount is in excess of current required capital levels for these institutions and could force reductions in overall leverage, including repurchase agreement financing, by these institutions in order to comply with the leverage ratio requirement, which could in turn limit the amount available for us to borrow or could increase our overall cost of financing.

There are various other recently adopted or proposed rules that could impact all regulated financial institutions in ways that may impact our ability to access financing.

In addition, the Federal Reserve has expressed concern over the generally unregulated nature of short-term wholesale funding markets including the repurchase agreement markets. Various suggestions have been made including capital surcharges as well as money market mutual fund reform (money market mutual funds are large supplier of liquidity to the repurchase markets). The outcome of any of these suggestions are uncertain but any capital surcharges or other reductions in repurchase agreement availability could have a material effect on the availability and cost of financing.

## CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. We base these estimates and judgments on historical experience and assumptions believed to be reasonable under current facts and circumstances. Actual results, however, may differ from the estimated amounts we have recorded.

Critical accounting policies are defined as those that require management's most difficult, subjective or complex judgments, and which may result in materially different results under different assumptions and conditions. The following discussion provides information on our accounting policies that require the most significant management estimates, judgments, or assumptions, or that management believes includes the most significant uncertainties, and are considered most critical to our results of operations or financial position.

*Fair Value Measurements.* As defined in ASC Topic 820, the fair value of a financial instrument is the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or liability. ASC Topic 820 provides a consistent definition of fair value which focuses on exit price and prioritizes, within a measurement of fair value, the use of market-based inputs over entity-specific inputs. In addition, ASC Topic 820 provides a framework for measuring fair value and establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. Please refer to Note 9 of the Notes to the Consolidated Financial Statements contained in this Annual Report on Form 10-K for a description of this hierarchy.

Our Agency MBS, as well a majority of our non-Agency MBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple pricing services and dealer quotes. Pricing services and dealers will have access to observable market information through their trading desks. We typically receive a total of three to six prices from pricing services and brokers for each of our securities; prices obtained from brokers are not binding on either the broker or us. Management does not adjust the prices received, but, for securities on which we receive five or more prices, the high and low prices are excluded from the calculation of the average price. In addition, management reviews the prices received for each security by comparing those prices to actual purchase and sale transactions, our internally modeled prices that are calculated based on observable market rates and credit spreads, and the prices that our borrowing counterparties use in financing the our securities. For any security for which significant variations in price exist (from other external prices received or from our internal price), management may exclude such prices from the calculation of the average price. The decision to exclude any price from use in the calculation of the fair values used in our consolidated financial statements is reviewed and approved by management independent of the pricing process. The average of the remaining prices received is used for the fair values included in our consolidated financial statements. If the price of a security is obtained from quoted prices for similar instruments or model-derived valuations whose inputs are observable, the security is classified as a level 2 security. If the inputs are unobservable, the security would be classified as a level 3 security.

As of December 31, 2013, less than 15% of our non-Agency MBS (and less than 2% of our total MBS) are comprised of securities for which there are not substantially similar securities that trade frequently, and therefore, estimates of fair value for

those level 3 securities are based primarily on management's judgment. Management determines the fair value of those securities by discounting the estimated future cash flows derived from cash flow models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant inputs into those pricing models are level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security's credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Generally, level 3 assets are most sensitive to the default rate and severity assumptions. Significant changes in any of these inputs in isolation would result in a significantly different fair value measurement, and accordingly, there is no assurance that our estimates of fair value are indicative of the amounts that would be realized on the ultimate sale or exchange of these assets.

*Amortization of Investment Premiums.* We amortize premiums and accrete discounts associated with the purchase of our MBS into interest income over the projected lives of our securities, including contractual payments and estimated prepayments, using the effective yield method. Estimates and judgments related to future levels of prepayments are critical to this determination, and they are difficult for management to predict. With respect to both RMBS and CMBS, mortgage prepayment expectations can change based on how changes in current and projected interest rates impact a borrower's likelihood of refinancing as well as other factors, including but not limited to real estate prices, borrowers' credit quality, changes in the stringency of loan underwriting practices, and lending industry capacity constraints. With respect to RMBS, modifications to existing programs such as HARP, or the implementation of new programs can have a significant impact on the rate of prepayments. Further, GSE buyouts of loans in imminent risk of default, loans that have been modified, or loans that have defaulted will generally be reflected as prepayments on our securities and increase the uncertainty around management's estimates. We utilize a third party service to assist in estimating prepayment rates on all MBS. We review these estimates monthly and compare the results to any available market consensus prepayment speeds. We also consider historical prepayment rates and current market conditions to assess the reasonableness of the prepayment rates estimated by the third party service. Actual and anticipated prepayment experience is reviewed monthly and effective yields adjusted for differences between the previously estimated future prepayments and the amounts actually received as well as changes in estimated future prepayments.

*Other-than-Temporary Impairments.* When the fair value of an available-for-sale security is less than its amortized cost as of the reporting date, the security is considered impaired. We assess our securities for impairment on at least a quarterly basis and determine if the impairments are either temporary or "other-than-temporary" in accordance with ASC Topic 320-10. Accounting literature does not define what it considers an other-than-temporary impairment ("OTTI") to be; however, it does state that an OTTI does not mean permanent impairment. The literature does provide some examples of factors which may be indicative of an OTTI, such as: (a) the length of time and extent to which market value has been less than cost; (b) the financial condition and near-term prospects of the issuer; and (c) the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

We assess our ability to hold any Agency MBS or non-Agency MBS with an unrealized loss until the recovery in its value. Our ability to hold any such MBS is based on the amount of the unrealized loss and significance of the related investment as well as our current leverage and anticipated liquidity. Although Fannie Mae and Freddie Mac are not explicitly backed by the full faith and credit of the United States, given their guarantee and commitments for support received from the Treasury as well as the credit quality inherent in Agency MBS, we do not typically consider any of the unrealized losses on our Agency MBS to be credit-related. For our non-Agency MBS, we review the credit ratings of these MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows which include any projected losses in order to evaluate whether we believe any portion of the unrealized loss at the reporting date is related to credit losses.

The determination as to whether an OTTI exists as well as its amount is subjective, as such determinations are based not only on factual information available at the time of assessment but also on management's estimates of future performance and cash flow projections. As a result, the timing and amount of any OTTI may constitute a material estimate that is susceptible to significant change. Our expectations with respect to our securities in an unrealized loss position may change over time, given, among other things, the dynamic nature of markets and other variables. For example, although we believe that the conservatorship of Fannie Mae and Freddie Mac has further strengthened their creditworthiness, there can be no assurance that these actions will be adequate for their needs. Accordingly, if these government actions are inadequate and the GSEs continue to suffer losses or cease to exist, our view of the credit worthiness of our Agency MBS could materially change, which may affect our assessment of OTTI for Agency MBS in future periods. Future sales or changes in our expectations with respect to Agency or non-Agency

securities in an unrealized loss position could result in us recognizing other-than-temporary impairment charges or realizing losses on sales of MBS in the future.

## FINANCIAL CONDITION

We invest primarily in Agency and non-Agency MBS, including RMBS, CMBS and CMBS IO securities. Agency MBS have a guaranty of principal payment by an agency of the U.S. government or a GSE such as Fannie Mae and Freddie Mac. Non-Agency MBS have no such guaranty of payment. The following tables provide information regarding our asset allocation based on fair value as of December 31, 2013 and as of the end of each of the four preceding quarters:

	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013	December 31, 2012
Agency MBS	85.5%	86.3%	85.9%	84.9%	83.6%
Non-Agency MBS	13.1%	12.3%	12.6%	13.6%	14.6%
Other investments	1.4%	1.5%	1.5%	1.5%	1.8%

	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013	December 31, 2012
RMBS	67.3%	68.5%	67.9%	65.0%	62.9%
CMBS	17.7%	17.2%	17.4%	19.3%	20.8%
CMBS IO	15.0%	14.3%	14.7%	15.7%	16.3%

### Agency MBS

Our investments in Agency RMBS are collateralized primarily by ARMs and hybrid ARMs. Our investments in Agency CMBS and CMBS IO are collateralized by fixed rate mortgage loans which generally have some form of prepayment protection provisions (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties).

Activity related to our Agency MBS for the year ended December 31, 2013 is as follows:

(amounts in thousands)	RMBS	CMBS	CMBS IO <sup>(1)</sup>	Total
Balance as of January 1, 2013	\$ 2,571,337	\$ 354,142	\$ 567,180	\$ 3,492,659
Purchases	1,067,754	35,415	138,323	1,241,492
Principal payments	(847,275)	(5,235)	—	(852,510)
Sales	(4,496)	(36,311)	(161,550)	(202,357)
Change in net unrealized gain	(61,982)	(12,322)	(10,134)	(84,438)
Net premium amortization	(33,188)	(4,188)	(73,492)	(110,868)
Balance as of December 31, 2013	\$ 2,692,150	\$ 331,501	\$ 460,327	\$ 3,483,978

(1) Amounts shown for CMBS IO represent premium only and exclude underlying notional values.

Overall, our investment in Agency MBS as of December 31, 2013 remained relatively unchanged compared to December 31, 2012. The bulk of our purchases during the year were Agency RMBS while the bulk of our asset sales were in Agency CMBS and CMBS IO. The majority of these sales resulted from proactive measures taken to manage through the market volatility we began to experience in June 2013 and that continued throughout the remainder of 2013. CMBS and CMBS IO generally had more liquidity in the second half of 2013 than RMBS. We also sold a portion of our CMBS IOs during 2013 because we believed the prepayment risk of holding a particular portion of these securities outweighed any potential benefit of continuing to hold them.

As of December 31, 2013, 63% of our Agency portfolio was comprised of Fannie Mae issued securities with the balance being comprised of 34% Freddie Mac issued securities and 3% Ginnie Mae issued securities compared to 65% Fannie Mae issued

securities and 29% Freddie Mac issued securities with the remaining 6% in Ginnie Mae issued securities as of December 31, 2012. As of December 31, 2013, 77% of our Agency MBS issued securities are variable-rate MBS with the remainder fixed-rate MBS compared to 73% variable-rate Agency MBS as of December 31, 2012. As of December 31, 2013, approximately 96% of our variable-rate Agency RMBS portfolio resets based on one-year LIBOR plus a weighted average rate of 1.78%, which is relatively unchanged from December 31, 2012.

The following table presents the weighted average coupon ("WAC") by weighted average MTR for the variable-rate portion of our Agency RMBS portfolio based on par value as of December 31, 2013 and December 31, 2012:

	December 31, 2013		December 31, 2012	
	Par Value	WAC	Par Value	WAC
<i>(\$ in thousands)</i>				
0-12 MTR	\$ 575,763	2.97%	\$ 523,711	3.94%
13-36 MTR	276,862	3.89%	300,186	4.03%
37-60 MTR	619,887	3.57%	471,159	4.03%
61-84 MTR	171,839	3.01%	620,099	3.28%
84-120 MTR	928,580	2.99%	490,759	3.39%
	<u>\$ 2,572,931</u>	<u>3.22%</u>	<u>\$ 2,405,914</u>	<u>3.69%</u>

During 2013, we received principal payments (both scheduled and unscheduled) on our Agency RMBS of \$847.3 million. Below is a table of the CPRs on our Agency RMBS for the periods indicated:

	Three Months Ended				
	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013	December 31, 2012
Agency RMBS	14.3%	23.8%	25.7%	24.8%	24.3%

CPRs on our Agency RMBS declined in the fourth quarter of 2013 compared to the third quarter of 2013 because refinancings decreased in response to increasing interest rates in the second half of 2013. As evidence of the decline in refinancing activity, the Mortgage Bankers Association Refinance Index fell by nearly 68% for the period from May 2013 to December 2013. RMBS prepayments will generally lag the refinance index by around three months.

#### **Non-Agency MBS**

Our purchases of non-Agency MBS are primarily investment grade securities (rated 'BBB' or better by at least one nationally recognized statistical ratings organizations). In 2013 most of our purchase activity was in CMBS and CMBS IO given the greater supply of these securities and the better risk-adjusted returns as compared to non-Agency RMBS. We typically purchase newer issue non-Agency MBS and have not generally purchased heavily discounted seasoned MBS. None of the non-Agency MBS in our portfolio as of December 31, 2013 or as of December 31, 2012 were purchased at a substantial discount.

Activity related to our non-Agency MBS for the year ended December 31, 2013 is as follows:

<i>(amounts in thousands)</i>	RMBS	CMBS	CMBS IO	Total
Balance as of January 1, 2013	\$ 11,038	\$ 486,342	\$ 113,942	\$ 611,322
Purchases	13,989	97,891	70,064	181,944
Principal payments	(5,554)	(50,927)	—	(56,481)
Sales	(5,631)	(136,287)	(10,263)	(152,181)
Change in net unrealized gain	(150)	(28,196)	(4,028)	(32,374)
Net accretion (amortization)	73	458	(18,578)	(18,047)
Balance as of December 31, 2013	<u>\$ 13,765</u>	<u>\$ 369,281</u>	<u>\$ 151,137</u>	<u>\$ 534,183</u>



The following table shows purchase price and related premium (discount) on purchases of our non-Agency MBS during 2013 by credit rating at the time of purchase:

Credit Rating At Purchase	For the Year Ended December 31, 2013	
	Purchase Price	Premium (Discount)
	<i>(amounts in thousands)</i>	
Non-Agency CMBS IO rated AAA <sup>(1)</sup>	\$ 70,064	\$ 70,064
Non-Agency CMBS rated A or BBB	97,891	(2,782)
Non-Agency RMBS non-investment grade	13,989	(11)
Total purchases	\$ 181,944	\$ 67,271

(1) For CMBS IO, premium is equal to purchase price as these securities have no principal associated with them. Notional amount of non-Agency CMBS IO purchased during the year ended December 31, 2013 was approximately \$2.2 billion.

Management does not anticipate any credit losses on our non-Agency MBS that were purchased at a discount during the year ended December 31, 2013.

The weighted average months to maturity for all of our non-Agency CMBS (including IO securities) as of December 31, 2013 was 78 months with 86% having origination dates of 2009 or later, and the remainder prior to 2000. Our non-Agency CMBS investments consist principally of investment grade securities (rated 'BBB' or better) and are primarily Freddie Mac Multifamily K Certificates on pools of recently originated multifamily mortgage loans. These certificates are not guaranteed by Freddie Mac, and, therefore, repayment is based solely on the performance of the underlying pool of loans. These loans have prepayment lock-out provisions which reduce the risk of early repayment of our investment.

The following table presents information for our non-Agency CMBS and CMBS IO investments by credit rating as of December 31, 2013 and as of December 31, 2012:

<i>(amounts in thousands)</i>	December 31, 2013					
	Non-Agency CMBS			Non-Agency CMBS IO		
	Fair Value	Net Unrealized Gain (Loss)	Related Borrowings	Fair Value	Net Unrealized Gain	Related Borrowings
AAA	\$ 40,379	\$ 2,126	\$ 35,637	\$ 149,692	\$ 555	\$ 106,787
AA	40,022	62	35,402	1,445	65	16
A	237,261	10,307	194,952	—	—	—
Below A/Not Rated	51,619	(641)	37,683	—	—	—
	<u>\$ 369,281</u>	<u>\$ 11,854</u>	<u>\$ 303,674</u>	<u>\$ 151,137</u>	<u>\$ 620</u>	<u>\$ 106,803</u>

<i>(amounts in thousands)</i>	December 31, 2012					
	Non-Agency CMBS			Non-Agency CMBS IO		
	Fair Value	Net Unrealized Gain	Related Borrowings	Fair Value	Net Unrealized Gain	Related Borrowings
AAA	\$ 156,180	\$ 8,934	\$ 134,678	\$ 112,106	\$ 4,935	\$ 86,731
AA	46,967	3,600	37,207	1,836	79	1,490
A	275,310	26,786	222,873	—	—	—
Below A/Not Rated	7,885	588	2,401	—	—	—
	<u>\$ 486,342</u>	<u>\$ 39,908</u>	<u>\$ 397,159</u>	<u>\$ 113,942</u>	<u>\$ 5,014</u>	<u>\$ 88,221</u>

The following table presents the geographic diversification of the collateral underlying our non-Agency CMBS by the top 5 states as of December 31, 2013 compared to December 31, 2012:

(\$ in thousands)	December 31, 2013		December 31, 2012	
	Market Value of Collateral	Percentage	Market Value of Collateral	Percentage
California	\$ 82,269	13.9%	\$ 75,001	12.8%
Florida	81,353	13.7%	74,723	12.7%
Texas	69,044	11.6%	71,964	12.2%
New York	32,240	5.4%	38,943	6.6%
Virginia	30,784	5.2%	30,734	5.2%
Remaining states (not exceeding 4.0% individually)	297,398	50.2%	296,743	50.5%
	<u>\$ 593,088</u>	<u>100.0%</u>	<u>\$ 588,108</u>	<u>100.0%</u>

#### *Derivative Assets and Liabilities*

Our derivative assets and liabilities consist of interest rate swap agreements and Eurodollar futures, both of which are viewed by us as economic hedges of our exposure to fluctuations in interest rates. Effective June 30, 2013 we voluntarily discontinued hedge accounting for all interest rate swaps that were previously designated as cash flow hedges under GAAP because certain accounting requirements to qualify for cash flow hedge treatment limited our ability to extend maturity dates for our repurchase agreements beyond 30 days.

During 2013 as a result of discontinuing cash flow hedge accounting and as a result of the additional cost associated with the Dodd-Frank requirements pertaining to interest rate swaps, we began using Eurodollar futures to mitigate interest rate risk as part of managing variability at specific points of the LIBOR curve. Eurodollar futures represent forward starting 3-month LIBOR contracts and allow us to synthetically replicate swap curves and/or hedge specific points on the swap curve where we may have duration risk by shorting contracts at various points of the LIBOR curve. We also entered into forward-starting interest rate derivatives, partly due to the Federal Reserve's policy with respect to a sustained low Federal Funds rate target which heavily influences the interest costs on our borrowings. As of December 31, 2013, the weighted average notional amount of interest rate derivatives instruments that will be effective for future periods are shown in the following table:

(\$ in thousands)	Interest Rate Swaps	Eurodollar Futures	Total	Weighted-Average Rate <sup>(1)</sup>
Effective 2014	\$ 751,148	\$ —	\$ 751,148	1.53%
Effective 2015	790,000	—	790,000	1.56%
Effective 2016	790,000	394,393	1,184,393	1.86%
Effective 2017	678,887	1,013,056	1,691,943	2.48%
Effective 2018	599,185	507,222	1,106,407	2.72%
Effective 2019	263,223	224,890	488,113	3.10%
Effective 2020	191,277	158,860	350,137	3.28%
Effective 2021	180,000	—	180,000	2.13%
Effective 2022	180,000	—	180,000	2.13%
Effective 2023	159,478	—	159,478	2.15%
Effective 2024	38,874	—	38,874	2.18%

(1) Weighted average rate is based on the weighted average notional outstanding.

Please refer to Note 6 of the Notes to the Consolidated Financial Statements contained with this Annual Report on Form 10-K as well as "Loss on Derivative Instruments, Net" within "Results of Operations" contained within this Item 7 for additional information related to our derivative assets and liabilities.

### **Repurchase Agreements**

Repurchase agreements increased a net \$16.6 million from December 31, 2012 to December 31, 2013 due to additional borrowings to finance our purchases of investments during the year ended December 31, 2013. During 2013 we began extending our maturities on our repurchase agreements up to six months in order to obtain lower borrowing rates. Please refer to Note 5 of the Notes to the Consolidated Financial Statements contained within this Annual Report on Form 10-K as well as "Interest Expense, Annualized Cost of Funds, and Effective Borrowings Costs" within "Results of Operations" and "Liquidity and Capital Resources" contained within this Item 7 for additional information relating to our repurchase agreements.

### **Shareholders' Equity**

Our shareholders' equity as of December 31, 2013 decreased \$30.8 million, or \$1.63 per common share, compared to December 31, 2012. This decrease was primarily the result of an increase in our accumulated other comprehensive loss of \$86.3 million, which was comprised of net unrealized losses in fair value of our MBS of \$116.7 million and a net unrealized gain of \$30.4 million related to increases in the fair value of our interest rate swaps which we accounted for as cash flow hedges until June 30, 2013. Other changes include our net income to common shareholders of \$60.2 million offset by common dividends declared of \$61.3 million, our Series B Preferred Stock issuance of \$54.3 million, additional common stock issuances of \$9.9 million, and stock repurchases and other forfeits of approximately \$7.6 million.

### **Supplemental Information**

The tables below present the allocation of our shareholders' equity to our assets and liabilities. The allocation of shareholders' equity is determined by subtracting the associated financing for each asset from that asset's carrying basis:

	As of December 31, 2013			
	Asset Carrying Basis	Associated Financing <sup>(1)</sup> / Liability Carrying Basis	Allocated Shareholders' Equity	% of Shareholders' Equity
(\$ in thousands)				
Agency MBS	\$ 3,483,978	\$ 3,149,470	\$ 334,508	57.1%
Non-Agency MBS	534,183	420,991	113,192	19.3%
Securitized mortgage loans	54,748	33,565	21,183	3.6%
Other investments	675	—	675	0.1%
Derivative assets (liabilities)	18,488	6,681	11,807	2.0%
Cash and cash equivalents	69,330	—	69,330	11.8%
Restricted cash	13,385	—	13,385	2.3%
Other assets/other liabilities	42,350	20,554	21,796	3.8%
	<u>\$ 4,217,137</u>	<u>\$ 3,631,261</u>	<u>\$ 585,876</u>	<u>100.0%</u>

As of December 31, 2012

(\$ in thousands)	Asset Carrying Basis	Associated Financing <sup>(1)</sup> / Liability Carrying Basis	Allocated Shareholders' Equity	% of Shareholders' Equity
Agency MBS	\$ 3,492,659	\$ 3,057,634	\$ 435,025	70.5 %
Non-Agency MBS	611,322	493,188	118,134	19.2 %
Securitized mortgage loans	70,823	43,810	27,013	4.4 %
Other investments	858	—	858	0.1 %
Derivative assets (liabilities)	—	42,537	(42,537)	(6.9)%
Cash and cash equivalents	55,809	—	55,809	9.1 %
Other assets/other liabilities	48,758	26,350	22,408	3.6 %
	<u>\$ 4,280,229</u>	<u>\$ 3,663,519</u>	<u>\$ 616,710</u>	<u>100.0 %</u>

(1) Associated financing related to investments includes repurchase agreements as well as payables pending for unsettled trades, if any, as of the date indicated, and non-recourse collateralized financing. Associated financing for derivative instruments represents the fair value of the derivative instruments in a liability position.

The tables below present the allocation of our invested capital by type of investment:

As of December 31, 2013

(\$ in thousands)	Asset Carrying Basis	Associated Financing	Invested Capital Allocation	% of Allocated Invested Capital
RMBS and loans	\$ 2,741,124	\$ 2,558,395	\$ 182,729	38.9%
CMBS and loans	720,996	569,123	151,873	32.4%
CMBS IO	611,464	476,508	134,956	28.7%
	<u>\$ 4,073,584</u>	<u>\$ 3,604,026</u>	<u>\$ 469,558</u>	<u>100.0%</u>

As of December 31, 2012

(\$ in thousands)	Asset Carrying Basis	Associated Financing	Invested Capital Allocation	% of Allocated Invested Capital
RMBS and loans	\$ 2,624,897	\$ 2,405,131	\$ 219,766	37.8%
CMBS and loans	869,643	658,399	211,244	36.4%
CMBS IO	681,122	531,102	150,020	25.8%
	<u>\$ 4,175,662</u>	<u>\$ 3,594,632</u>	<u>\$ 581,030</u>	<u>100.0%</u>

RESULTS OF OPERATIONS

Net income and core net operating income

Net income to common shareholders for the year ended December 31, 2013 decreased \$11.8 million compared to the year ended December 31, 2012. Net interest income increased by \$9.7 million, but was offset by an increase of \$5.9 million in preferred dividends due to the issuance of our Series B Preferred Stock, an increase in loss on derivative instruments of \$9.2 million, and a lower gain on sale of investments of \$5.1 million.

We are providing certain non-GAAP financial measures, including "core net operating income", which exclude certain GAAP items, primarily in order to provide a more meaningful comparison of current period results to those of prior periods during which we utilized cash flow hedge accounting. Please refer to the section "Non-GAAP Financial Measures" contained in Item 6 for additional important information on this and other non-GAAP financial measures discussed throughout this Annual Report on Form 10-K.

The following table presents a reconciliation of our GAAP net income to our core net operating income for the periods presented:

	Year Ended December 31,		
	2013	2012	2011
<i>(\$ in thousands, except per share amounts)</i>			
GAAP net income to common shareholders	\$ 60,167	\$ 72,006	\$ 39,812
Amortization of de-designated cash flow hedges <sup>(1)</sup>	5,193	—	—
Change in fair value on derivative instruments, net <sup>(2)</sup>	1,128	254	2,227
Litigation settlement and related costs	—	—	8,240
Loss on non-recourse collateralized financing	—	—	1,970
Gain on sale of investments, net	(3,354)	(8,461)	(2,096)
Fair value adjustments, net	652	(735)	676
Core net operating income to common shareholders	\$ 63,786	\$ 63,064	\$ 50,829
Core net operating income to common shareholders per share	\$ 1.17	\$ 1.19	\$ 1.32

*(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.*

*(2) Represents net realized and unrealized gains and losses on derivatives and excludes net periodic interest costs made on these instruments.*

Core net operating income to common shareholders for 2013 was comparable to 2012, increasing by \$0.7 million while declining \$0.02 on a per share basis. The 1.0% increase in core net operating income was due to higher net interest income from a larger investment portfolio offset by higher periodic interest costs on derivatives from increased hedging activities. Core net operating income per share declined as a result of the higher average common shares outstanding during 2013.

#### **Interest Income and Asset Yields**

The majority of our interest income is from our MBS portfolio with the remainder resulting from investments in securitized mortgage loans and other investments. The following tables present interest income and weighted average yields by type of MBS investment for the periods indicated:

	Year Ended December 31,					
	2013			2012		
	Interest Income	Average Balance <sup>(1)</sup>	Effective Yield <sup>(2)</sup>	Interest Income	Average Balance <sup>(1)</sup>	Effective Yield <sup>(2)</sup>
<i>(\$ in thousands)</i>						
Agency RMBS	\$ 56,376	\$ 2,835,130	1.99%	\$ 50,319	\$ 2,250,477	2.24%
Agency CMBS	11,726	323,174	3.59%	11,601	307,691	3.69%
Agency CMBS IO	25,760	520,689	4.95%	15,841	328,541	5.02%
Total Agency	93,862	3,678,993	2.55%	77,761	2,886,709	2.71%
Non-Agency RMBS	659	12,641	5.22%	884	15,401	5.74%
Non-Agency CMBS	23,383	415,212	5.63%	24,568	406,918	6.06%
Non-Agency CMBS IO	5,725	118,759	4.82%	4,515	71,882	5.39%
Total Non-Agency	29,767	546,612	5.45%	29,967	494,201	5.95%
Total MBS portfolio	\$ 123,629	\$ 4,225,605	2.92%	\$ 107,728	\$ 3,380,910	3.18%

	Year Ended December 31,					
	2012			2011		
	Interest Income	Average Balance <sup>(1)</sup>	Effective Yield <sup>(2)</sup>	Interest Income	Average Balance <sup>(1)</sup>	Effective Yield <sup>(2)</sup>
<i>(\$ in thousands)</i>						
Agency RMBS	\$ 50,319	\$ 2,250,477	2.24%	\$ 45,013	\$ 1,567,408	2.87%
Agency CMBS	11,601	307,691	3.69%	9,711	250,333	3.81%
Agency CMBS IO	15,841	328,541	5.02%	2,090	28,203	7.71%
Total Agency	77,761	2,886,709	2.71%	56,814	1,845,944	3.07%
Non-Agency RMBS	884	15,401	5.74%	795	13,086	6.08%
Non-Agency CMBS	24,568	406,918	6.06%	16,668	275,469	6.05%
Non-Agency CMBS IO	4,515	71,882	5.39%	1,362	14,647	9.30%
Total Non-Agency	29,967	494,201	5.95%	18,825	303,202	6.21%
Total MBS portfolio	\$ 107,728	\$ 3,380,910	3.18%	\$ 75,639	\$ 2,149,146	3.51%

(1) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

(2) Effective yields are based on annualized amounts. Recalculation of effective yields may not be possible using data provided because certain components of interest income use a 360-day year for the calculation while others use actual number of days in the year.

The following tables present the estimated impact of changes in average yields and average balances on the increase (decrease) in interest income for the periods indicated:

	Year Ended		
	December 31, 2013 vs. December 31, 2012		
	Due to Change in		
(amounts in thousands)	Increase (Decrease)	Average Balance <sup>(1)</sup>	Average Yield
Agency MBS	\$ 16,101	\$ 21,674	\$ (5,573)
Non-Agency MBS	(200)	3,052	(3,252)
Total	\$ 15,901	\$ 24,726	\$ (8,825)

	Year Ended		
	December 31, 2012 vs. December 31, 2011		
	Due to Change in		
(amounts in thousands)	Increase (Decrease)	Average Balance <sup>(1)</sup>	Average Yield
Agency MBS	\$ 20,947	\$ 33,036	\$ (12,089)
Non-Agency MBS	11,142	11,614	(472)
Total	\$ 32,089	\$ 44,650	\$ (12,561)

(1) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

Our interest income from MBS for the year ended December 31, 2013 increased compared to the year ended December 31, 2012 due to an increase in the average balance of our MBS portfolio, and in particular an increase in our Agency and non-Agency CMBS IO portfolios. The impact of a larger average balance was partially offset by lower effective yields earned on our investments due to lower weighted average coupons (primarily on MBS purchased during 2013) and higher premium amortization during the year ended December 31, 2013. Similarly, interest income from MBS for the year ended December 31, 2012 increased compared to the year ended December 31, 2011 due to a larger average balance (and particularly in our CMBS IO portfolio) partially offset by lower effective yields.

The following table presents the components of our interest income by MBS investment type for the periods indicated:

	Year Ended		
	December 31,		
	2013	2012	2011
(amounts in thousands)			
<b>Agency:</b>			
Gross interest	\$ 204,727	\$ 159,288	\$ 84,639
Net premium amortization	(110,865)	(81,527)	(27,825)
Total interest income	\$ 93,862	\$ 77,761	\$ 56,814
Average balance of unamortized premium, net	700,545	470,568	131,241
<b>Non-Agency:</b>			
Gross interest	\$ 47,783	\$ 39,919	\$ 21,925
Net premium amortization	(18,016)	(9,952)	(3,100)
Total interest income	\$ 29,767	\$ 29,967	\$ 18,825
Average balance of unamortized premium, net	\$ 100,998	\$ 54,060	\$ 9,065

Net premium amortization increased for the year ended December 31, 2013 compared to the year ended December 31, 2012 as the average balance of our net unamortized premiums increased \$276.9 million for the year ended December 31, 2013

compared to the year ended December 31, 2012. Our average balance of unamortized premium during the year ended December 31, 2013 was more heavily weighted toward higher priced CMBS and CMBS IO than in 2012.

Net premium amortization increased for the year ended December 31, 2012 compared to the year ended December 31, 2011 primarily because of purchases of higher-priced Agency CMBS IO and Agency RMBS during 2012 compared to 2011. In addition, we experienced higher prepayment activity in 2012 versus 2011, and we also increased our forecasted prepayment speed during the second quarter of 2012 in response to declining mortgage rates and the HARP refinance program.

The following table presents the remaining components of our interest income for the periods indicated:

(amounts in thousands)	Year Ended December 31,					
	2013		2012		2011	
	Interest Income	Average Balance	Interest Income	Average Balance	Interest Income	Average Balance
Securitized mortgage loans	\$ 3,436	\$ 62,718	\$ 5,395	\$ 91,873	\$ 7,615	\$ 133,198
Other investments	67	1,750	425	19,375	123	1,096

Interest income earned on our securitized mortgage loans is decreasing year over year due to the declining average balance outstanding as the mortgage loans continue to pay down. These securitized assets represent both commercial and single-family mortgage loans that are well-seasoned and were originated by us from 1992 to 1997.

Interest income earned from our other investments decreased for the year ended December 31, 2013 compared to the year ended December 31, 2012 and compared to the year ended December 31, 2011 due to a declining average balance of our unsecuritized mortgage loans. In addition, during the first six months of 2012, we held an investment of \$105.5 million in Freddie Mac Senior Unsecured Reference Notes on which we earned interest income of \$0.3 million.

#### Interest Expense, Annualized Cost of Funds, and Effective Borrowing Costs

The following table summarizes the components of interest expense as well as average balances and annualized cost of funds for the periods indicated:

(\$ in thousands)	Year Ended December 31,		
	2013	2012	2011
Repurchase agreements	\$ 24,113	\$ 19,341	\$ 7,965
Interest rate swap expense from cash flow hedging	8,796	14,448	11,604
Amortization of de-designated cash flow hedges <sup>(1)</sup>	5,193	—	—
Non-recourse collateralized financing and other expenses	926	1,358	4,513
Total interest expense	\$ 39,028	\$ 35,147	\$ 24,082
Average balance of repurchase agreements	\$ 3,773,744	\$ 3,033,634	\$ 1,904,489
Average balance of non-recourse collateralized financing	24,101	35,713	98,491
Average balance of borrowings	\$ 3,797,845	\$ 3,069,347	\$ 2,002,980
Annualized cost of funds <sup>(2)</sup>	1.01%	1.12%	1.19%

(1) Amount recorded in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

(2) Rates shown are based on annualized interest expense amounts divided by average balance of borrowings. Recalculation of annualized cost of funds using total interest expense shown in the table may not be possible because certain expense items use a 360-day year for the calculation while others use actual number of days in the year.



The following tables present the amount that our interest expense from repurchase agreements increased for the periods indicated due to changes in average balances and changes in average rates:

	Year Ended		
	December 31, 2013 vs. December 31, 2012		
	Increase in Interest Expense	Due to Change in	
(amounts in thousands)		Average Balance	Average Borrowing Rate
Repurchase agreements	\$ 4,772	\$ 4,719	\$ 53

	Year Ended		
	December 31, 2012 vs. December 31, 2011		
	Increase in Interest Expense	Due to Change in	
(amounts in thousands)		Average Balance	Average Borrowing Rate
Repurchase agreements	\$ 11,376	\$ 4,722	\$ 6,654

As shown in the table above, the majority of the increase in our interest expense from repurchase agreement borrowings for the year ended December 31, 2013 compared to the year ended December 31, 2012 is due to an increase in the average balance outstanding during the past year. The average borrowing rate on our repurchase agreement borrowings for the year ended December 31, 2013 remained stable at 0.63% compared to the year ended December 31, 2012 despite extending maturities of our repurchase agreements during 2013. This is because our committed facility of repurchase agreement borrowings, which incurs a higher rate of financing, was used during all of 2013 versus being used during less than half of 2012, so its average balance outstanding during the year ended December 31, 2013 comprised a larger portion of our total average borrowings outstanding compared to 2012. Our average interest rate on uncommitted repurchase agreement borrowings was 3 basis points lower for the year ended December 31, 2013 compared to the year ended December 31, 2012. Interest expense from repurchase agreement borrowings for the year ended December 31, 2012 compared to the year ended December 31, 2011 increased because we significantly increased financing of our purchases of CMBS IO securities during 2012 which incur a higher average rate of financing than financing secured by RMBS or CMBS.

Total interest expense shown on our consolidated statements of net income for the years ended December 31, 2013, 2012, and 2011 includes net periodic interest costs of our derivative instruments while they were designated as cash flow hedges. Effective June 30, 2013, management discontinued the use of cash flow hedge accounting, therefore the \$8.8 million included in interest expense for the year ended December 31, 2013 represents approximately half of the total net periodic interest costs of derivative instruments. Subsequent to June 30, 2013, all net periodic interest costs of our derivative instruments are now recorded within "gain on derivative instruments, net" on our consolidated statements of net income instead of within "interest expense". The following table presents our total net periodic interest costs related to our derivative instruments segregated by their location on our consolidated statements of net income for the periods indicated:

	Year Ended		
	December 31,		
(amounts in thousands)	2013	2012	2011
Included in "interest expense" (from cash flow hedging)	\$ 8,796	\$ 14,448	\$ 11,604
Included in "loss on derivative instruments, net"	8,948	654	598
Total net periodic interest costs of derivative instruments:	\$ 17,744	\$ 15,102	\$ 12,202

The increase in net periodic interest costs of derivative instruments for the year ended December 31, 2013 compared to the year ended December 31, 2012 resulted from additional derivative instruments we entered into during 2013 in order to actively manage our interest rate exposure given the rising rate environment. Similarly, we added additional derivative instruments during

the year ended December 31, 2012 compared to the year ended December 31, 2011, resulting in increased net periodic interest costs for 2012 compared to 2011. We added derivative instruments during 2012 as a result of increased repurchase agreement borrowings as well as lengthening of the duration of our investment portfolio from our 2012 MBS purchases. As the duration of our portfolio increases, we will generally add additional derivatives to economically hedge the uncertainty of interest expense cash flows on repurchase agreements anticipated for the future.

Interest expense from our non-recourse collateralized financing decreased for the year ended December 31, 2013 compared to the years ended December 31, 2012 and 2011. The balance outstanding on our securitization financing bonds continues to decline year over year as we use the principal payments received on the securitized mortgage loans collateralizing these bonds to pay down the principal. During the year ended December 31, 2011, we also had non-recourse collateralized financing provided by the Federal Reserve Bank of New York under its Term Asset-Backed Securities Loan Facility ("TALF"), which was paid off in the first quarter of 2012.

In summary, our total annualized cost of funds for the year ended December 31, 2013 was 0.11% lower than our total annualized cost of funds for the year ended December 31, 2012 partly because this measure only includes approximately half of our total net periodic interest costs for the year ended December 31, 2013 (as shown in the prior table). In addition, our non-recourse collateralized financing, which has a higher rate of financing, comprises a smaller portion of our average balance of total financings for the year ended December 31, 2013 compared to the year ended December 31, 2012. As stated earlier, our average borrowing rate from our repurchase agreements was stable at 0.63% for the year ended December 31, 2013 compared to the year ended December 31, 2012. Total annualized cost of funds for the year ended December 31, 2012 was 0.07% lower than for the year ended December 31, 2011 because of the significant decrease in our average balance of non-recourse collateralized financing which carries a higher rate of financing. This average balance decreased because we paid off the TALF financing early in 2012 as mentioned above. The annualized cost of funds for our repurchase agreements including interest rate swap expenses was 1.10% for the year ended December 31, 2012 compared to 1.02% for the year ended December 31, 2011.

Because our annualized cost of funds does not incorporate our total net periodic interest costs of derivative instruments, management utilizes a non-GAAP financial measure "effective borrowing costs". Although we have elected to discontinue cash flow hedge accounting for our interest rate swaps, we view our interest rate derivative instruments as economic hedges of our exposure to higher interest rates. Effective borrowing costs equal GAAP interest expense less the amortization from de-designated cash flow hedges (which is included in GAAP interest expense) plus any net periodic interest costs of derivative instruments which are not already included in GAAP interest expense as a result of cash flow hedge de-designation. In other words, our effective borrowing costs include all interest expense incurred from our repurchase agreements, non-recourse collateralized financing, and derivative instruments (excluding changes in fair value and amortization of AOCI from cash flow hedge de-designation). The tables below present a reconciliation of GAAP interest expense and annualized costs of funds to our effective borrowing costs and related rates during the periods indicated:

	Year Ended December 31,					
	2013		2012		2011	
	Amount	Rate <sup>(4)</sup>	Amount	Rate <sup>(4)</sup>	Amount	Rate <sup>(4)</sup>
GAAP interest expense/annualized cost of funds	\$ 39,028	1.01 %	\$ 35,147	1.12%	\$ 24,082	1.19%
Amortization of de-designated cash flow hedges <sup>(1)</sup>	(5,193)	(0.15)%	—	—%	—	—%
Net periodic interest costs from derivative instruments <sup>(2)</sup>	8,948	0.24 %	654	0.02%	598	0.03%
Effective borrowing costs/rate	\$ 42,783	1.10 %	\$ 35,801	1.14%	\$ 24,680	1.22%
Average balance of borrowings <sup>(3)</sup>	\$ 3,797,845		\$ 3,069,347		\$ 2,002,980	

<sup>(1)</sup> Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

(2) Amount equals the net interest payments (including accrued amounts) related to interest rate derivatives during the period which are recorded in "loss on derivative instruments, net" and not already included in "interest expense" in accordance with GAAP.

(3) Average balances are calculated as a simple average of the daily borrowings outstanding for both repurchase agreement and securitization financing.

(4) Rates shown are based on annualized interest expense amounts divided by average balance of borrowings. Recalculation of annualized cost of funds and effective borrowing rates using interest expense shown in the table may not be possible because certain expense items use a 360-day year for the calculation while others use actual number of days in the year.

Effective borrowing costs increased \$7.0 million for the year ended December 31, 2013 versus the same period in 2012, of which \$4.8 million resulted primarily from an increased average balance of repurchase agreement borrowings used to fund our investment purchases and \$2.6 million resulted from increased net periodic interest costs due to additional derivative instruments we used to hedge exposure to increases in interest rates during 2013. These increases were offset by a decrease of \$0.4 million in our interest expense from non-recourse collateralized financing. In spite of the increase in our effective borrowing costs, our effective borrowing rate decreased for the year ended December 31, 2013 versus for the year ended December 31, 2012 because our non-recourse collateralized financing, which has a higher rate of financing, comprised a smaller portion of our average balance of total financings for the year ended December 31, 2013 compared to the year ended December 31, 2012. In addition, our effective borrowing rate decreased because, although our total net periodic interest costs increased \$2.6 million for 2013 versus 2012, these costs decreased as a percentage of our average repurchase agreement borrowings for the year ended December 31, 2013 compared to the year ended December 31, 2012. As stated earlier, our average borrowing rate from our repurchase agreements was stable at 0.63% for the year ended December 31, 2013 compared to the year ended December 31, 2012.

Effective borrowing costs for the year ended December 31, 2012 decreased 0.08% compared to the year ended December 31, 2011 for the same reasons that annualized cost of funds decreased from 2012 to 2013.

#### **Net Interest Income and Net Interest Spread**

To adjust for the impact of cash flow hedge de-designation and to make our results more comparable to prior periods and to competitors using cash flow hedge accounting, management uses the non-GAAP financial measures "adjusted net interest income" and "adjusted net interest spread". These measures include total net periodic interest cost of derivative instruments in our net interest income and net interest spread. The following table reconciles GAAP net interest income and related net interest spread to our adjusted net interest income and adjusted net interest spread for the periods indicated:

	Year Ended December 31, 2013					
	2013		2012		2011	
	Amount	Yield	Amount	Yield	Amount	Yield
(\$ in thousands)						
GAAP interest income	\$ 127,132	2.96 %	\$ 113,548	3.25 %	\$ 83,377	3.64 %
GAAP interest expense	39,028	1.01 %	35,147	1.12 %	24,082	1.19 %
Net interest income/spread	88,104	1.95 %	78,401	2.13 %	59,295	2.45 %
Amortization of de-designated cash flow hedges <sup>(1)</sup>	5,193	0.15 %	—	— %	—	— %
Net periodic interest costs of derivative instruments <sup>(2)</sup>	(8,948)	(0.24)%	(654)	(0.02)%	(598)	(0.03)%
Adjusted net interest income/spread	\$ 84,349	1.86 %	\$ 77,747	2.11 %	\$ 58,697	2.42 %
Average interest earning assets <sup>(3)</sup>	\$ 4,290,073		\$ 3,492,158		\$ 2,283,440	
Average balance of borrowings <sup>(4)</sup>	\$ 3,797,845		\$ 3,069,348		\$ 2,002,981	

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

(2) Amount equals the net interest payments (including accrued amounts) related to interest rate derivatives during the period which are recorded in "loss on derivative instruments, net" and not already included in "interest expense" in accordance with GAAP.

(3) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

(4) Average balances are calculated as a simple average of the daily borrowings outstanding for both repurchase agreement and securitization financing.

Although our net interest income and adjusted net interest income have been increasing from 2011 through 2013, our net interest spread and adjusted net interest spread have been decreasing overall during the past two years. This downward trend has been driven primarily by declining effective yields on our overall investment portfolio, resulting from purchases of lower yielding MBS at higher premiums as well as coupon resets on our variable-rate RMBS. Over 96% of our variable-rate RMBS portfolio resets based on the 12-month LIBOR rate, which has been generally decreasing over the past two years, causing declines in coupon rates on our variable-rate RMBS as they reach their reset dates. Although our gross interest income has increased over the past two years, this increase is primarily the result of the growth of our investment portfolio.

#### **Loss on Derivative Instruments, Net**

As discussed earlier, we discontinued cash flow hedge accounting for all of our interest rate swaps effective June 30, 2013. All activity related to our interest rate swap agreements is now recorded within "loss on derivative instruments, net" on our consolidated statement of net income. The following table provides information on the components of our loss on derivative instruments, net for the periods indicated:

	Year Ended December 31,		
	2013	2012	2011
(amounts in thousands)			
Net periodic interest costs of derivative instruments <sup>(1)</sup>	\$ 8,948	\$ 654	\$ 598
Change in fair value of derivative instruments, net	1,128	254	2,227
Loss on derivative instruments, net	\$ 10,076	\$ 908	\$ 2,825

(1) Amount equals the net interest payments (including accrued amounts) related to interest rate derivatives during the period which are recorded in "loss on derivative instruments, net" and not already included in "interest expense" in accordance with GAAP.

Included in our loss on derivative instruments, net for the year ended December 31, 2013 is a favorable change in fair value of \$18.3 million for our interest rate swap agreements offset by net periodic interest costs of \$8.9 million and an unfavorable change in fair value of \$19.4 million related to Eurodollar futures which we began purchasing during the third quarter of 2013 to hedge our exposure to rising interest rates. The unfavorable change in the Eurodollar futures was primarily due to the decline in forward Eurodollar interest rates compared to the rates at inception of the contract.

During the years ended December 31, 2012 and December 31, 2011, our loss on derivative instruments, net includes periodic interest costs and changes in fair value related to three interest rate swap agreements with a combined notional amount of \$27.0 million and a weighted average pay-fixed rate of 2.88% which we chose to not designate as cash flow hedges at the time of inception. All other activity related to interest rate swaps held during the years ended December 31, 2012 and December 31, 2011 was either reported within other comprehensive income as "change in fair value of derivative instruments, net" or as a portion of "interest expense" on our consolidated statements of net income.

#### **Gain on Sale of Investments, Net**

The following table provides information related to our gain on sale of investments, net for the periods indicated:

	Year Ended December 31,					
	2013		2012		2011	
	Amortized cost basis sold	Gain (loss) on sale of investments, net	Amortized cost basis sold	Gain on sale of investments, net	Amortized cost basis sold	Gain on sale of investments, net
<i>(amounts in thousands)</i>						
<b>Type of Investment</b>						
Agency RMBS	\$ 4,496	\$ (254)	\$ 61,534	\$ 2,112	\$ 152,165	\$ 1,240
Agency CMBS	36,311	689	—	—	26,662	856
Agency CMBS IO	161,550	2,010	23,939	194	—	—
Non-Agency RMBS	5,631	(340)	—	—	—	—
Non-Agency CMBS	136,287	793	34,315	3,013	—	—
Non-Agency CMBS IO	10,263	456	—	—	—	—
Securitized mortgage loan liquidation	—	—	3,612	2,072	—	—
Freddie Mac Senior Unsecured Reference Notes	—	—	99,966	1,070	—	—
	<u>\$ 354,538</u>	<u>\$ 3,354</u>	<u>\$ 223,366</u>	<u>\$ 8,461</u>	<u>\$ 178,827</u>	<u>\$ 2,096</u>

Although generally a normal part of our operations due to ordinary portfolio reallocations, our sales of MBS investments for the year ended December 31, 2013 increased due to management's decision to reduce portfolio risk given the volatile market environment experienced in 2013.

The increased gain on sale of investments, net for the year ended December 31, 2012 compared to the year ended December 31, 2011 reflects price appreciation during 2012. We purchased the Freddie Mac Senior Unsecured Reference Notes during 2012 with proceeds from our capital raise in February 2012 as a temporary investment and subsequently sold these notes in favor of Agency MBS. We sold the MBS securities during 2012 as a result of portfolio rebalancing and to reduce our exposure to prepayment risk in the case of the Agency RMBS.

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

Compensation and benefits decreased \$0.6 million for the year ended December 31, 2013 compared to the year ended December 31, 2012 due to lower bonuses earned as well as an increased amount of bonuses being paid in restricted stock in lieu of cash. Other general and administrative expenses for the year ended December 31, 2013 increased approximately \$1.0 million compared to the year ended December 31, 2012 due to increased expenses related to portfolio management and analysis tools. General and administrative expenses annualized as a percentage of shareholders' equity was 2.1% for the year ended December 31, 2013 compared to 2.3% for the year ended December 31, 2012.

General and administrative expenses for the year ended December 31, 2012 increased approximately \$2.8 million compared to the year ended December 31, 2011. The majority of this increase was due to increased incentive compensation expenses as well as an increase in our number of employees. General and administrative expenses as a percentage of shareholder's equity decreased to 2.3% for the year ended December 31, 2012 compared to 2.8% for the year ended December 31, 2011 as we grew our equity capital during 2012 without incurring significant additional overhead expenses.

### **LIQUIDITY AND CAPITAL RESOURCES**

Our primary sources of liquidity include borrowings under repurchase arrangements, monthly principal and interest payments we receive on our investments, and cash. Additional sources may also include proceeds from the sale of investments,

equity offerings, issuances of collateralized financings, and payments received from counterparties from interest rate swap agreements. We use our liquidity to fund our investment purchases and other operating costs, to pay down borrowings, to make payments to counterparties as required under interest rate swap agreements, and to pay dividends on our common stock.

Our available liquid assets as of December 31, 2013 were \$208.7 million compared to \$186.0 million as of December 31, 2012. As of December 31, 2013, our liquid assets consist of unrestricted cash and cash equivalents of \$69.3 million, \$127.2 million in unencumbered Agency MBS, and \$12.1 million of unrestricted cash collateral received on derivative positions. Unencumbered Agency MBS are considered part of our liquid assets as we may pledge them to lenders and interest rate swap counterparties if we experience a margin call (which is discussed below). We monitor our current and forecasted available liquidity on a daily basis. Our liquid assets may fluctuate from period to period based on our investment activities and whether we have recently raised, but not yet deployed, equity capital. However, we will maintain sufficient liquidity based on the sensitivity analysis and debt-to-equity requirements discussed below, to support our operations and meet our anticipated liquidity needs.

We perform sensitivity analysis on our liquidity based on changes in the value of our investments due to changes in interest rates, market credit spreads, lender haircuts and prepayment speeds. We also closely monitor our debt-to-invested equity ratio (which is the ratio of debt financing to invested equity for any investment) as part of our liquidity management process as well as our overall enterprise level debt-to-equity and the ratio of our available liquidity to outstanding repurchase agreement borrowings. Our current operating policies provide that recourse borrowings including repurchase agreements used to finance investments will be in the range of three (3) to ten (10) times our invested equity capital depending on the investment type. Our maximum target leverage is up to ten (10) times our invested capital for Agency RMBS, eight (8) times for Agency CMBS and five (5) times for Agency CMBS IO. With respect to non-Agency MBS, our maximum target leverage is up to five (5) times our invested capital in non-Agency CMBS and RMBS, and up to four (4) times our invested capital in non-Agency CMBS IO. The maximum targets represent fixed limits for leveraging our investment capital. We may change our leverage targets based on market conditions and our perceptions of the liquidity of our investments.

On an enterprise level basis, our current operating policies limit our total liabilities-to-shareholders' equity to seven (7) times our shareholders' equity. On an enterprise-wide basis, our total liabilities decreased to 6.2 times shareholders' equity as of December 31, 2013 from 6.4 times shareholders' equity as of September 30, 2013 and 6.8 times shareholders' equity as of June 30, 2013. Given the market volatility in asset prices and in order to reduce risk to the Company, we have been reducing our leverage since the second quarter of 2013 by selling approximately \$170.2 million of our assets since June 30, 2013 and by not re-investing a substantial portion of the principal payments received on our investments.

In 2013 we had ample sources of liquidity to fund our activities and operations. The ability to fund our operations in the future depends in large measure on the availability of credit through repurchase agreement financing and the liquidity of our investments. Credit markets in general are stable, and there is ample availability. However, these markets and the liquidity of our investments remain susceptible to exogenous shocks as was experienced in the financial crisis in 2008 and 2009. In addition, in recent quarters U.S. financial regulatory agencies (such as the Office of Financial Research in the U.S. Treasury have expressed some concern about the stability of repurchase agreement financing for mortgage REITs in a rising interest rate environment, and regulatory reform in the form of certain provisions of the Basel III capital framework and the Dodd-Frank Wall Street Reform and Consumer Protection Act could impact the overall availability of credit. In times of severe market stress, repurchase agreement availability could be rapidly reduced and the terms on which we can borrow could be materially altered, particularly given the focus on these markets by the regulators. Competition from other REITs, banks, hedge funds, and the federal government for capacity with our repurchase agreement lenders could also reduce our repurchase agreement availability. While we do not anticipate such events in the near term, a reduction in our borrowing capacity could force us to sell assets in order to repay our lenders or could otherwise restrict our ability to operate our business.

Depending on our liquidity levels, the condition of the credit markets, and other factors, we may from time to time consider the issuance of debt, equity, or other securities, the proceeds of which could provide additional liquidity for our operations. While we will attempt to avoid dilutive or otherwise costly issuances, depending on market conditions, in order to manage our liquidity we could be forced to issue equity or debt securities which are dilutive to our capital base or our profitability.

#### ***Repurchase Agreements***

Our repurchase agreement borrowings generally have a term of between one and six months and carry a rate of interest based on a spread to an index such as LIBOR. As of December 31, 2013, the weighted average original term to maturity was 114 days. Repurchase agreements are generally renewable at the discretion of our lenders and do not contain guaranteed roll-over terms. Given the short-term and uncommitted nature of most of our repurchase agreement financing, we attempt to maintain unused capacity under our existing repurchase agreement credit lines with multiple counterparties which helps protect us in the event of a counterparty's failure to renew existing repurchase agreements either with favorable terms or at all. As of December 31, 2013,

we had 31 repurchase agreement counterparties and \$3.6 billion in repurchase agreement borrowings outstanding with 22 of those counterparties at a weighted average borrowing rate of 0.61%. As of December 31, 2012, we had \$3.6 billion outstanding with 19 counterparties at a weighted average borrowing rate of 0.70%.

For our repurchase agreement borrowings, we are required to post and maintain margin to the lender (i.e., collateral in excess of the repurchase agreement financing) in order to support the amount of the financing. This excess collateral is often referred to as a "haircut" (and which we also refer to as equity at risk). As the collateral pledged is generally MBS, the value of the collateral can fluctuate with changes in market conditions. If the fair value of the collateral falls below the initial haircut amount, the lender has the right to demand additional margin, or collateral, to increase the haircut back to the initial amount. These demands are typically referred to as "margin calls". There is no minimum amount of collateral value decline required before the lender could initiate a margin call, and we typically will experience margin calls for downward fluctuations in collateral values. Declines in the value of investments occur for any number of reasons including but not limited to changes in interest rates, changes in ratings on an investment, changes in actual or perceived liquidity of the investment, or changes in overall market risk perceptions. Additionally, values in Agency RMBS will also decline from the payment delay feature of those securities. Agency RMBS have a payment delay feature whereby Fannie Mae and Freddie Mac announce principal payments on Agency RMBS but do not remit the actual principal payments and interest for 20 days in the case of Fannie Mae and 40 days in the case of Freddie Mac. Because these securities are financed with repurchase agreements, the repurchase agreement lender generally makes a margin call for an amount equal to the product of their advance rate on the repurchase agreement and the announced principal payments on the Agency RMBS. This causes a temporary use of our liquidity to meet the margin call until we receive the principal payments and interest 20 to 40 days later.

The following table presents certain quantitative information regarding our repurchase agreement borrowings for the periods indicated:

<i>(amounts in thousands)</i>	<b>Balance Outstanding As of Period End</b>	<b>Average Balance Outstanding For the Quarter Ended</b>	<b>Maximum Balance Outstanding During the Quarter Ended</b>
December 31, 2013	\$ 3,580,754	\$ 3,603,477	\$ 3,675,290
September 30, 2013	3,674,850	3,836,249	4,071,773
June 30, 2013	4,071,392	4,042,340	4,255,294
March 31, 2013	3,708,255	3,612,319	3,752,000
December 31, 2012	3,564,128	3,626,402	3,689,052
September 30, 2012	3,670,972	3,265,816	3,671,736
June 30, 2012	3,111,924	2,885,215	3,112,966
March 31, 2012	2,686,198	2,348,048	2,686,232
December 31, 2011	2,093,793	2,107,136	2,136,919
September 30, 2011	2,053,686	2,115,970	2,167,302
June 30, 2011	2,133,249	1,950,438	2,157,195
March 31, 2011	1,848,883	1,434,700	1,848,883

Generally, our repurchase agreement balances outstanding as of each period end have been closely correlated to our average balances outstanding for each quarter. Since the end of the second quarter of 2013, however, we have methodically reduced our repurchase agreement borrowings through sales of assets and have not been fully reinvesting principal payments received on our MBS as discussed above given market conditions.

The following table discloses our repurchase agreement amounts outstanding (excluding deferred costs related to our committed two-year repurchase facility) and the value of the related collateral pledged by geographic region of our counterparties as of December 31, 2013:

<i>(amounts in thousands)</i>	<b>Amount Outstanding</b>	<b>Market Value of Collateral Pledged</b>
North America	\$ 2,129,144	\$ 2,350,960
Asia	861,170	901,070
Europe	590,683	641,240
	<u>\$ 3,580,997</u>	<u>\$ 3,893,270</u>

The following table presents the weighted average haircut for Agency and non-Agency MBS as of the dates indicated:

	<b>December 31, 2013</b>	<b>September 30, 2013</b>	<b>June 30, 2013</b>	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Agency MBS	6.8%	6.7%	6.6%	7.3%	7.4%
Non-Agency MBS	20.1%	20.0%	19.7%	19.1%	19.5%

The counterparties with whom we have the greatest amounts of equity at risk may vary significantly during any given period due to the short-term and generally uncommitted nature of the repurchase agreement borrowings. Equity at risk is defined as the amount pledged as collateral to the repurchase agreement counterparty in excess of the repurchase agreement amount outstanding. The following tables present the five counterparties with whom we had the greatest amounts of equity at risk as of December 31, 2013 and as of December 31, 2012:

<i>(amounts in thousands)</i>	<b>December 31, 2013</b>	
	<b>Amount Outstanding</b>	<b>Equity at risk</b>
Well Fargo Bank, N.A. and affiliates <sup>(1)</sup>	\$ 371,753	\$ 91,769
JP Morgan Securities, LLC	240,024	39,397
South Street Financial Corporation	601,354	29,331
Credit Suisse Securities LLC	210,861	25,093
Bank of America Securities LLC	226,768	23,886
Remaining counterparties	1,930,237	102,797
	<u>\$ 3,580,997</u>	<u>\$ 312,273</u>

<i>(amounts in thousands)</i>	<b>December 31, 2012</b>	
	<b>Amount Outstanding</b>	<b>Equity at risk</b>
Well Fargo Bank, N.A. and affiliates <sup>(1)</sup>	\$ 365,470	\$ 110,708
Bank of America Securities LLC	287,319	37,623
Credit Suisse Securities LLC	245,220	52,037
Nomura Securities International, Inc.	206,201	21,266
JP Morgan Securities, LLC	199,389	36,097
Remaining counterparties	2,260,529	113,645
	<u>\$ 3,564,128</u>	<u>\$ 371,376</u>

*(1) Amount excludes deferred costs related to our committed two-year repurchase facility with Wells Fargo Bank National which had a remaining balance of \$0.2 million and \$0.7 million as of December 31, 2013 and December 31, 2012, respectively.*

Our repurchase agreement counterparties require us to comply with various operating and financial covenants. The financial covenants include requirements that we maintain minimum shareholders' equity (usually a set minimum, or a percentage of the highest amount of shareholders' equity since the date of the agreement), maximum decline in shareholders' equity (expressed as a percentage decline in any given period), and limits on maximum leverage (as a multiple of shareholders' equity). Operating requirements include, among other things, requirements to maintain our status as a REIT and to maintain our listing on the NYSE. Violations of one or more of these covenants could result in the lender declaring an event of default which would result in the termination of the repurchase agreement and immediate acceleration of amounts due thereunder. In addition, some of the agreements contain cross default features, whereby default with one lender simultaneously causes default under agreements with other



lenders. Violations could also restrict us from paying dividends or engaging in other transactions that are necessary for us to maintain our REIT status.

We monitor and evaluate on an ongoing basis the impact these customary financial covenants may have on our operating and financing flexibility. Currently, we do not believe we are subject to any covenants that materially restrict our financing flexibility. As noted above, we have one repurchase agreement lender which requires that we maintain our enterprise level leverage as of quarter end at less than 7 times our shareholders' equity. Our overall debt was 6.2 times our shareholders' equity as of December 31, 2013.

#### **Derivatives**

Our interest rate derivative instruments require us to post initial margin at inception and variation margin based on subsequent changes in the fair value of the derivatives. The collateral posted as margin by us is typically in the form of cash or Agency MBS. Generally, as interest rates decline we will have to post collateral with the counterparty, and, as interest rates increase, the counterparty will deposit collateral with us or return our collateral (typically when the amount of collateral required to be posted exceeds a certain dollar amount). As of December 31, 2013, we had Agency MBS with a fair value of \$3.2 million posted as credit support under these agreements.

#### **Dividends**

As a REIT, we are required to distribute to our shareholders amounts equal to at least 90% of our REIT taxable income for each taxable year after consideration of our tax NOL carryforwards. We generally fund our dividend distributions through our cash flows from operations. If we make dividend distributions in excess of our operating cash flows during the period, whether for purposes of meeting our REIT distribution requirements or other strategic reasons, those distributions are generally funded either through our existing cash balances or through the return of principal from our investments (either through repayment or sale). As of December 31, 2013, we had an estimated NOL carryforward of \$142.3 million. We may utilize our NOL carryforward to offset our REIT distribution requirements, subject to a limitation of \$13.5 million per year.

#### **Contractual Obligations**

The following table summarizes our contractual obligations by payment due date as of December 31, 2013:

(amounts in thousands) Contractual Obligations: <sup>(1)</sup> <sup>(2)</sup>	Payments due by period				
	Total	< 1 year	1-3 years	3-5 years	> 5 years
Securitization financing <sup>(3)</sup>	\$ 13,134	\$ 3,326	\$ 4,503	\$ 2,602	\$ 2,703
Operating lease obligations	169	82	43	44	—
Total	\$ 13,303	\$ 3,408	\$ 4,546	\$ 2,646	\$ 2,703

(1) Amounts shown exclude interest obligations as those amounts are not significant.

(2) Amounts outstanding under our repurchase agreements are excluded from the table because these amounts represent short-term financing. All amounts outstanding under our repurchase agreements as of December 31, 2013 are due within 180 days.

(3) Represents financing that is non-recourse to us as the debt is payable solely from loans and securities pledged as collateral. Payments due by period were estimated based on the principal repayments forecasted for the underlying loans and securities, substantially all of which is used to repay the associated financing outstanding.

#### **Off-Balance Sheet Arrangements**

As of December 31, 2013, we do not believe that any off-balance sheet arrangements exist that are reasonably likely to have a material effect on our current or future financial condition, results of operations, liquidity or capital resources.

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

Please refer to Note 1 of the Notes to the Consolidated Financial Statements for information on recent accounting updates to the ASC which have been issued but are not yet effective.

## FORWARD-LOOKING STATEMENTS

Certain written statements in this Annual Report on Form 10-K that are not historical facts constitute “forward-looking statements” within the meaning of Section 27A of the 1933 Act and Section 21E of the Exchange Act. Statements in this report addressing expectations, assumptions, beliefs, projections, future plans and strategies, future events, developments that we expect or anticipate will occur in the future, and future operating results are forward-looking statements. Forward-looking statements are based upon management’s beliefs, assumptions, and expectations as of the date of this report regarding future events and operating performance, taking into account all information currently available to us, and are applicable only as of the date of this report. Forward-looking statements generally can be identified by use of words such as “believe”, “expect”, “anticipate”, “estimate”, “plan”, “may”, “will”, “intend”, “should”, “could” or similar expressions. We caution readers not to place undue reliance on our forward-looking statements, which are not historical facts and may be based on projections, assumptions, expectations, and anticipated events that do not materialize. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statement whether as a result of new information, future events, or otherwise.

We make forward-looking statements in this Annual Report on Form 10-K regarding:

- Our business and investment strategy including our ability to generate acceptable risk-adjusted returns and our target investment allocations;
- Monetary policy of the Federal Reserve;
- Our financing and hedging strategy, including our target leverage ratios, anticipated trends in financing costs, changes to the derivative instruments to which we are a party, and changes to government regulation of hedging instruments and our use of these instruments;
- Our investment portfolio composition and target investments;
- Our investment portfolio performance, including the fair value, yields, and forecasted prepayment speeds of our investment portfolio;
- Our liquidity and ability to access financing, and the anticipated availability and cost of financing;
- Our use of and restrictions on using our tax NOL carryforward;
- The status of pending litigation;
- Estimates of future interest expenses related to the Company's derivative instruments;
- The status of regulatory rule-making or review processes and the status of reform efforts in the repurchase agreement financing market;
- Market, industry and economic trends; and
- Interest rates.

Forward-looking statements are inherently subject to risks, uncertainties and other factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. Not all of these risks and other factors are known to us. New risks and uncertainties arise over time, and it is not possible to predict those events or how they may affect us. The projections, assumptions, expectations or beliefs upon which the forward-looking statements are based can also change as a result of these risks or other factors. If such a risk or other factor materializes in future periods, our business, financial condition, liquidity and results of operations may vary materially from those expressed or implied in our forward-looking statements.

While it is not possible to identify all factors, some of the factors that may cause actual results to differ from historical results or from any results expressed or implied by forward-looking statements, or that may cause our projections, assumptions, expectations or beliefs to change, include the following:

- the risks and uncertainties referenced in this Annual Report on Form 10-K, particularly those set forth under Part I, Item 1A, “Risk Factors”;
- our ability to find suitable reinvestment opportunities;
- changes in economic conditions;
- changes in interest rates and interest rate spreads, including the repricing of interest-earning assets and interest-bearing liabilities;

- our investment portfolio performance particularly as it relates to cash flow, prepayment rates and credit performance;
- actual or anticipated changes in Federal Reserve monetary policy;
- adverse reactions in financial markets related to the budget deficit or national debt of the United States government; potential or actual default by the United States government on Treasury securities; and potential or actual downgrades to the sovereign credit rating of the United States;
- the cost and availability of financing, including the future availability of financing due to changes to regulation of, and capital requirements imposed upon, financial institutions;
- the cost and availability of new equity capital;
- changes in our use of leverage;
- the quality of performance of third-party servicer providers of our loans and loans underlying our securities;
- the level of defaults by borrowers on loans we have securitized;
- changes in our industry;
- increased competition;
- changes in government regulations affecting our business;
- changes in the repurchase agreement financing markets and other credit markets;
- changes to the market for interest rate swaps and other derivative instruments, including changes to margin requirements on derivative instruments;
- government initiatives to support the U.S financial system and U.S. housing and real estate markets; or to reform the U.S. housing finance system including by imposing standards for originating residential mortgage loans;
- GSE reform or other government policies and actions; and
- ownership shifts under Section 382 that further limit the use of our tax NOL carryforward.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We seek to manage various risks inherent in our business strategy, which include interest rate, prepayment, reinvestment, market value, credit, and liquidity risks. We do not seek to avoid risk completely, but we attempt to manage these risks while earning an acceptable return for our shareholders. Below is a discussion of the risks in our strategy and our efforts to manage these risks.

### **Interest Rate Risk**

Investing in interest-rate sensitive investments on a leveraged basis subjects us to interest rate risk. Interest rate risk arises primarily because of the mismatch between interest-rate reset dates or maturity of our assets and our liabilities during a specified period. The costs of our borrowings are generally based on prevailing market rates and reset more frequently than interest rates on our assets. In addition, our adjustable rate assets may have limits or caps on the amount that an interest rate may reset while our liabilities do not have rate reset caps. During a period of rising interest rates (particularly short term rates), our borrowing costs will increase faster than our asset yields, negatively impacting our net interest income. The amount of the impact will depend on the composition of portfolio and on the effectiveness of our hedge instruments at the time, as well as the magnitude and the duration of the increase in interest rates. Changes in interest rates, particularly rapid changes, may also negatively impact the market value of our investments which reduces our book value. See "Market Value Risk" below for further discussion of the risks to the market value of our investments.

We attempt to manage our exposure to changes in interest rates by investing in instruments that have shorter maturities or interest reset dates, entering into hedging transactions (such as interest rate swaps and Eurodollar futures) and by managing our investment portfolio within interest rate risk tolerances set by our Board of Directors. Our current goal is to maintain a net portfolio duration (a measure of interest rate risk) within a range of 0.5 to 1.5 years. Our portfolio duration has drifted outside of our target range at various times due to changes in market conditions, changes in actual or expected prepayment rates on our investments, changes in interest rates, changes in market credit spreads, and activity in our investment portfolio. In addition, duration is driven by model inputs, and in the case of Agency RMBS, the most important inputs include anticipated prepayment speeds. Estimates of prepayment speeds can vary significantly by investor for the same security and therefore estimates of security and portfolio duration can vary significantly.

*Effect of Changes in Interest Rates on Net Interest Margin Cash Flows and Market Value.* The table below shows the sensitivity of our projected net interest margin cash flows and the projected market value of our investments and derivative instruments (for those carried at fair value on our balance sheet, including all derivative instruments) as they existed as of December 31, 2013 based on an instantaneous parallel shift in market interest rates as set forth in the table. The "percentage change in projected net interest margin cash flows" included in the table below is based on estimated changes to the projected net interest margin cash flows on the investment portfolio over the next twenty-four (24) months. Apart from the changes in interest rates, the projections are based upon a variety of other assumptions including investment prepayment speeds, credit performance, and the availability and cost of financing over the projected period. The "percentage change in projected market value" included in the table below is based on the immediate change in market value of the investment portfolio based on the instantaneous shift in market interest rates. The projections for market value do not assume any change in market credit spreads.

The table below assumes a static portfolio along with an instantaneous parallel shift in interest rates and does not consider any reinvestment or rebalancing of the investment portfolio or additional hedging activity. Changes in types of investments, changes in future interest rates, changes in market credit spreads, changes in the shape of the yield curve, the availability of financing and/or the mix of our investments and financings including hedging instruments may cause actual results to differ significantly from the modeled results. In addition, declines in market value of our investments and derivative instruments may occur from changes in market expectations on future interest rates and/or Federal Reserve monetary policy which are not modeled in the table below. Other factors will also impact the amounts set forth below, such as whether we raise additional capital or change our investment allocations or strategies. Accordingly, amounts shown below could differ materially from actual results. There can be no assurance that assumed events used for the model below will occur, or that other events will not occur, that will affect the outcomes; therefore, the tables below and all related disclosures constitute forward-looking statements.

Basis Point Change in Yields	December 31, 2013	
	Percentage change in projected net interest margin cash flows <sup>(1)</sup>	Percentage change in projected market value <sup>(2)</sup>
+100	(5.0)%	(1.9)%
+50	(2.5)%	(0.9)%
0	—%	—%
-50	3.1%	0.5%
-100	1.7%	0.6%

(1) Includes changes in interest expense from the financings for our investments as well as our derivative instruments.

(2) Includes changes in market value of our investments and derivative instruments, but excludes changes in market value of our financings because they are not carried at fair value on our balance sheet.

Management also considers changes in the shape of the interest rate curves in assessing how much interest rate risk exists in the investment portfolio. The table below shows the percentage change in projected market value of our investment portfolio net of hedges for changes in the shape of the U.S. Treasury curve (with similar changes to the interest rate swap curve and Eurodollar curves) as of December 31, 2013.

Basis point change in 2-year yield	Basis point change in 10-year yield	Percentage change in projected market value
0	+25	(0.16)%
+10	+50	(0.45)%
+10	+75	(0.67)%
+10	+100	(0.92)%
+25	0	(0.30)%
+50	0	(0.51)%
-10	-50	0.26%

Our adjustable rate investments have interest rates which are predominantly based on one-year LIBOR and contain periodic (or interim) and lifetime interest rate caps which limit the amount by which the interest rate may reset on the investment. The following table presents information about the lifetime and interim interest rate caps (where interim interest rate caps include both initial adjustments of interest rates which generally are 5% as well as periodic adjustments which generally are 2%) on our adjustable-rate Agency MBS portfolio as of December 31, 2013:

Lifetime Interest Rate Caps		Interim Interest Rate Caps	
	% of Total		% of Total
>7.0% to 10.0%	85.5%	1.0%	0.4%
>10.0% to 11.0%	11.1%	2.0%	17.6%
>11.0% to 12.1%	3.4%	5.0%	82.0%
	100.0%		100.0%

#### Market Value Risk

Market value risk generally represents the risk of loss from the change in the value of our investment securities and derivatives due to fluctuations in interest rates and changes in the perceived risk in owning such financial instrument. Securities in our investment portfolio and derivative instruments are reflected at their estimated fair value, with the difference between their cost basis and estimated fair value reflected in accumulated other comprehensive income (loss) in the case of our investments and in our consolidated statements of net income in the case of our derivative instruments. As demonstrated in the tables above, in a rising interest rate environment, the fair value of our securities tends to decrease; conversely, in a decreasing interest rate environment, the fair value of our securities tends to increase. The fair value of our securities will also fluctuate due to changes in market credit spreads (which represent the market's valuation of the perceived riskiness of assets relative to risk-free rates), changes in actual prepayments or expected prepayments, the perceived liquidity of the investment, actual or expected credit performance, and other factors. We attempt to manage market value risk by managing our exposure to these factors (although we do not actively attempt to manage market value risk from changes in credit spreads). For example, the types of derivative instruments we are currently using to hedge the interest rates on our debt tend to increase in value when our investment portfolio decreases in value, although not a one-to-one correlation. See the analysis in the "Interest Rate Risk" section above, which presents the estimated change in our portfolio value given changes in market interest rates. Regardless of whether an investment is carried in our financial statements as available for sale or as trading, we will monitor the change in its market value. In particular, we will monitor changes in the value of investments collateralizing our repurchase agreements for liquidity management and other purposes, including maintaining appropriate collateral margins.

Fluctuations in market credit spreads will vary based on the type of investments. In general, market credit spreads will have less volatility for Agency MBS than non-Agency MBS. The table below is an estimate of the projected change in our portfolio market value given the indicated change in market credit spreads as of December 31, 2013:

Basis Point Change in Market Credit Spreads	Percentage change in projected market value
+50	(2.3)%
+25	(1.2)%
0	—%
-25	1.2%
-50	2.4%

#### Prepayment and Reinvestment Risk

Prepayment risk is the risk of an early, unscheduled return of principal on an investment. We are subject to prepayment risk from premiums paid on investments which we acquire. In general, purchase premiums on our investments are amortized as a reduction in interest income using the effective yield method under GAAP, adjusted for the actual and anticipated prepayment activity of the investment. An increase in the actual or expected rate of prepayment will typically accelerate the amortization of purchase premiums, thereby reducing the yield/interest income earned on such assets. Principal prepayments on our investments

are influenced by changes in market interest rates and a variety of economic, geographic, and other factors beyond our control. In addition, actions taken by the U.S. government could increase prepayments, as discussed in Part I, Item 1A. "Risk Factors" in this Annual Report on Form 10-K.

Prepayment risk results from both our RMBS and CMBS investments. Loans underlying our CMBS and CMBS IO securities generally have some form of prepayment protection provisions (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties). Without these prepayment protection provisions, prepayment risk on CMBS IO would be particularly acute as these investments have no principal balance (interest payments are based on the notional amount of the underlying commercial loans) and therefore are all premium. Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay; however, the amount of the prepayment penalty required to be paid may decline over time, and as loans age, interest rates decline, or market values of collateral supporting the loan increase, prepayment penalties may lessen as an economic disincentive to the borrower over time. Generally our experience has been that prepayment lock-out and yield maintenance provisions result in stable prepayment performance from period to period. There are no prepayment protections, however, if the loan defaults and the loan is partially or wholly repaid earlier as a result of loss mitigation actions taken by the underlying loan servicer. Historically, our default experience on loans in CMBS and CMBS IO has been relatively low. Delinquencies as of the last reported date are less than 1% for our CMBS IO securities.

Loans underlying our RMBS do not have any specific prepayment protection. All of the loans underlying our RMBS are ARMs or Hybrid ARMs. Prepayments on these loans accelerate in a declining rate environment, as the loans age, and as they near their interest rate reset date, particularly the initial reset date. Our prepayment models anticipate acceleration of prepayments in these events. To the extent the actual prepayments exceed our modeled prepayments, or if we change our future prepayment expectations, we will record adjustments to our premium amortization which may negatively impact our net interest income and could impact the market value of our RMBS.

As an indication of our prepayment risk on our RMBS portfolio, the following table summarizes information regarding the net premium and weighted average coupon by months until interest rate reset (or until maturity in the case of fixed-rate securities) for our RMBS portfolio designated as available-for-sale as of December 31, 2013:

	Agency RMBS		Non-Agency RMBS	
	Net Premium	WAC	Net Premium (Discount)	WAC
<i>(amounts in thousands)</i>				
0-12 months to reset	\$ 42,082	2.97%	\$ —	\$ —
13-24 months to reset	11,234	3.73%	—	—
25-60 months to reset	46,419	3.66%	(9)	4.25%
> 60 months to reset	54,496	2.99%	—	—
Fixed rate	(11)	2.51%	(329)	4.80%
Total premium, net	\$ 154,220	3.22%	\$ (338)	4.61%
Par/notional balance	\$ 2,591,568		\$ 13,845	
Premium, net as a % of par value	6.0%		(2.4)%	

We seek to manage our prepayment risk on our MBS by diversifying our investments, seeking investments which we believe will have superior prepayment performance, and investing in securities which have some sort of prepayment prohibition or yield maintenance (as is the case with CMBS and CMBS IO). With respect to RMBS, we will seek to invest in RMBS where we believe the underlying loans have favorable prepayment characteristics such as lower loan balances or favorable origination, borrower or geographic characteristics.

We are also subject to reinvestment risk as a result of the prepayment, repayment and sales of our investments. Yields on assets in which we invest now are generally lower than yields on existing assets that we may sell or which may be repaid, due to lower overall interest rates and more competition for these as investment assets. As a result, our interest income may decline in the future, thereby reducing earnings per share. In order to maintain our investment portfolio size and our earnings, we need to reinvest our capital into new interest-earning assets. If we are unable to find suitable reinvestment opportunities, interest income on our investment portfolio and investment cash flows could be negatively impacted.

## Credit Risk

Credit risk is the risk that we will not receive all contractual amounts due on investments that we own due to default by the borrower or due to a deficiency in proceeds from the liquidation of the collateral securing the obligation. We are also exposed to credit risk on investments that we own at a premium. For investments owned at premiums, defaults on the underlying loan typically result in the complete loss of any remaining unamortized premium we paid.

We attempt to mitigate our credit risk by purchasing Agency MBS and higher quality non-Agency MBS. Agency MBS have credit risk to the extent that Fannie Mae or Freddie Mac fails to remit payments on the MBS for which they have issued a guaranty of payment. Given the improved financial performance and conservatorship of these entities and the continued support of the U.S. government, we believe this risk is low. For our non-Agency MBS, we will generally only purchase investment grade securities (rated 'BBB' or better by a least one of the nationally recognized statistical ratings organizations). For securities, such as CMBS IOs, where we have a higher premium at risk, we seek to invest in securities where we are comfortable with the credit profile of the loans underlying the security.

Certain of our non-Agency MBS were purchased at modest discounts to their par value. The discounts resulted from the MBS having coupon interest rates that were less than the prevailing market rates for similar securities when they were purchased, and not from anticipated credit losses on the collateral. We believe the underlying collateral value currently, and at the time of purchase, is adequate to prevent any credit losses on the respective MBS.

The following table presents information on our non-Agency MBS by credit rating as of December 31, 2013:

<i>(amounts in thousands)</i>	December 31, 2013			
	CMBS	CMBS IOs	RMBS	Weighted average
AAA	\$ 40,379	\$ 149,692	\$ —	35.6%
AA	40,022	1,445	—	7.8%
A	237,261	—	—	44.4%
Below A or not rated	51,619	—	13,765	12.2%
	<u>\$ 369,281</u>	<u>\$ 151,137</u>	<u>\$ 13,765</u>	<u>100.0%</u>

With respect to our securitized mortgage loans, these loans are well-seasoned, thereby lowering our average loan-to-value (“LTV”) ratio and decreasing our risk of loss. Other efforts to mitigate credit risk include maintaining a risk management function that monitors and oversees the performance of the servicers of the mortgage loans as well as providing an allowance for loan loss as required by GAAP.

## Liquidity Risk

We have liquidity risk principally from the use of recourse repurchase agreements to finance our ownership of securities. In general, our repurchase agreements provide a source of uncommitted short-term financing that finances a longer-term asset, thereby creating a mismatch between the maturity of the asset and of the associated financing. Our repurchase agreements are renewable at the discretion of our lenders and do not contain guaranteed roll-over terms. If we fail to repay the lender at maturity, the lender has the right to immediately sell the collateral and pursue us for any shortfall if the sales proceeds are inadequate to cover the repurchase agreement financing. In addition, repurchase agreements are collateral based and declines in the market value of our investments subject us to liquidity risk.

For further information, including how we attempt to mitigate liquidity risk and our liquidity position, please refer to “Liquidity and Capital Resources” in Part II, Item 7 of this Annual Report on Form 10-K.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our consolidated financial statements and the related notes, together with the Reports of the Independent Registered Public Accounting Firm thereon, are set forth on pages [F-1](#) through F-30 of this Annual Report on Form 10-K.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not applicable.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### Disclosure Controls and Procedures

Our management evaluated, with the participation of our Principal Executive Officer and Principal Financial Officer, the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of the end of the period covered by this report. Based on that evaluation, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2013 to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

### Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three months ended December 31, 2013 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) of the Exchange Act. Because of inherent limitations, a system of internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to change in conditions, or that the degree of compliance with policies or procedures may deteriorate.

Our management evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") (1992) in "Internal Control-Integrated Framework." Based on that evaluation, our principal executive officer and principal financial officer concluded that our internal control over financial reporting was effective as of the end of the period covered by this report.

The Company's internal control over financial reporting as of December 31, 2013 has been audited by BDO USA, LLP, the independent registered public accounting firm that also audited the Company's consolidated financial statements included in this Annual Report on Form 10-K. The attestation report of BDO USA, LLP on the effectiveness of the Company's internal control over financial reporting appears on page F-4 herein.

## **ITEM 9B. OTHER INFORMATION**

None.



### PART III.

#### ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information about our executive officers required by this item is included in Part I, Item I of this Annual Report on Form 10-K under the caption “Executive Officers of the Registrant”. The remaining information required by Item 10 will be included in our definitive proxy statement for use in connection with our 2014 Annual Meeting of Shareholders (“2014 Proxy Statement”) under the captions “Election of Directors,” “Committees of the Board,” “Code of Ethics” and “Section 16(a) Beneficial Ownership Reporting Compliance,” and is incorporated herein by reference.

#### ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 will be included in the 2014 Proxy Statement under the captions “Compensation Committee,” “Executive Compensation” and “Directors’ Compensation,” and is incorporated herein by reference.

#### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth information as of December 31, 2013 with respect to the our equity compensation plans under which shares of our common stock are authorized for issuance.

	Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (1)
<b>Equity Compensation Plans Approved by Shareholders:</b>			
2009 Stock and Incentive Plan	—	—	1,550,118
<b>Equity Compensation Plans Not Approved by Shareholders (2)</b>	—	—	—
<b>Total</b>	—	\$ —	1,550,118

(1) Reflects shares available to be granted under the 2009 Stock and Incentive Plan in the form of stock options, stock appreciation rights, stock awards, dividend equivalent rights, performance share awards, stock units and incentive awards.

(2) The Company does not have any equity compensation plans that have not been approved by shareholders.

The remaining information required by Item 12 will be included in the 2014 Proxy Statement under the caption “Ownership of Stock” and is incorporated herein by reference.

#### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Item 13 will be included in the 2014 Proxy Statement under the captions “Related Person Transactions” and “Director Independence,” and is incorporated herein by reference.

#### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by Item 14 will be included in the 2014 Proxy Statement under the caption “Audit Information,” and is incorporated herein by reference.

**PART IV.**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES**

(a) Documents filed as part of this report:

1. and 2. Financial Statements and Schedules:  
The information required by this section of Item 15 is set forth in the Consolidated Financial Statements and Reports of Independent Registered Public Accounting Firm beginning at page [F-1](#) of this Annual Report on Form 10-K. The index to the Financial Statements is set forth at page [F-2](#) of this Annual Report on Form 10-K.

<u>Exhibit No.</u>	<u>Description</u>
3.1	Restated Articles of Incorporation, effective July 9, 2008 (incorporated herein by reference to Exhibit 3.1 to Dynex's Current Report on Form 8-K filed July 11, 2008).
3.1.1	Articles of Amendment to the Restated Articles of Incorporation, effective July 30, 2012 (incorporated herein by reference to Exhibit 3.1.1 to Dynex's Registration Statement on Form 8-A filed August 1, 2012).
3.1.2	Articles of Amendment to the Restated Articles of Incorporation, effective April 15, 2013 (incorporated herein by reference to Exhibit 3.1 to Dynex's Current Report on Form 8-K filed April 16, 2013).
3.1.3	Articles of Amendment to the Restated Articles of Incorporation, effective June 11, 2013 (incorporated herein by reference to Exhibit 3.1.3 to Dynex's Quarterly Report on Form 10-Q filed August 9, 2013).
3.2	Amended and Restated Bylaws, amended as of December 12, 2013 (filed herewith).
10.1*	Dynex Capital, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.1 to Dynex's Annual Report on Form 10-K for the year ended December 31, 2004.)
10.1.1*	409A Amendment to Dynex Capital, Inc. 2004 Stock Incentive Plan, dated December 31, 2008 (incorporated herein by reference to Exhibit 10.1.1 to Dynex's Annual Report on Form 10-K for the year ended December 31, 2008).
10.2*	Form of Stock Option Agreement for Non-Employee Directors under the Dynex Capital, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.2 to Dynex's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
10.3*	Form of Stock Appreciation Rights Agreement for Senior Executives under the Dynex Capital, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.3 to Dynex's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
10.5*	Severance Agreement between Dynex Capital, Inc. and Stephen J. Benedetti dated June 11, 2004 (incorporated herein by reference to Exhibit 10.5 to Dynex's Annual Report on Form 10-K for the year ended December 31, 2007).
10.5.1*	409A Amendment to Severance Agreement between Dynex Capital, Inc. and Stephen J. Benedetti, dated December 31, 2008 (incorporated herein by reference to Exhibit 10.1.1 to Dynex's Annual Report on Form 10-K for the year ended December 31, 2008).
10.7*	Dynex Capital, Inc. 401(k) Overflow Plan, effective July 1, 1997 (incorporated herein by reference to Exhibit 10.7 to Dynex's Quarterly Report on Form 10-Q for the quarter ended March 31, 2008).
10.9*	Dynex Capital, Inc. Performance Bonus Program, as approved August 5, 2010 (incorporated herein by reference to Exhibit 10.9 to Dynex's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010).
10.11*	Dynex Capital, Inc. 2009 Stock and Incentive Plan, effective as of May 13, 2009 (incorporated herein by reference to Appendix A to Dynex's Proxy Statement filed April 3, 2009).
10.12*	Employment Agreement, dated as of July 31, 2009, between Dynex Capital, Inc. and Byron L. Boston (incorporated herein by reference to Exhibit 10.12 to Dynex's Quarterly Report on Form 10-Q for the quarter ended September 30, 2009).

<u>Exhibit No.</u>	<u>Description</u>
10.14	Equity Distribution Agreement between Dynex Capital, Inc. and JMP Securities LLC, dated June 24, 2010 (incorporated herein by reference to Exhibit 10.14 to Dynex's Current Report on Form 8-K filed June 24, 2010).
10.14.1	Amendment No. 1 to Equity Distribution Agreement between Dynex Capital, Inc. and JMP Securities LLC, dated December 23, 2011 (incorporated herein by reference to Exhibit 10.14.1 to Dynex's Current Report on Form 10-K filed December 23, 2011).
10.16*	Form of Restricted Stock Agreement for Executive Officers under the Dynex Capital, Inc. 2009 Stock and Incentive Plan (incorporated herein by reference to Exhibit 10.16 to Dynex's Annual Report on Form 10-K for the year ended December 31, 2010).
10.17*	Base salaries for executive officers of Dynex Capital, Inc. (filed herewith).
10.18*	Non-employee directors' annual compensation for Dynex Capital, Inc. (incorporated herein by reference to Exhibit 10.18 to Dynex's Annual Report on Form 10-K for the year ended December 31, 2010).
10.20*	Letter Agreement between Dynex Capital, Inc. and Byron L. Boston, dated September 7, 2011 (incorporated by reference to Exhibit 10.20 to Dynex's Current Report on Form 8-K filed September 9, 2011).
10.21	Underwriting Agreement, dated January 27, 2012, by and among Dynex Capital, Inc., Credit Suisse Securities (USA) LLC, Merrill Lynch, Pierce, Fenner & Smith Incorporated and JMP Securities LLC (incorporated herein by reference to Exhibit 1.1 to Dynex's Current Report on Form 8-K filed January 31, 2012).
10.22	Underwriting Agreement, dated July 25, 2012, by and among Dynex Capital, Inc., J.P. Morgan Securities LLC, Barclays Capital Inc. and Jefferies & Company, Inc. (incorporated herein by reference to Exhibit 1.1 to Dynex's Current Report on Form 8-K filed July 30, 2012).
10.23	Master Repurchase and Securities Contract dated as of August 6, 2012 between Issued Holdings Capital Corporation, Dynex Capital, Inc. (as guarantor) and Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 10.23 to Dynex's Current Report on Form 8-K filed August 8, 2012).
10.23.1	Amendment No. 1 to Master Repurchase and Securities Contract dated as of October 1, 2013 between Issued Holdings Capital Corporation, Dynex Capital, Inc. (as guarantor) and Wells Fargo Bank, N.A. (incorporated herein by reference to Exhibit 10.23.1 to Dynex's Current Report on Form 8-K filed October 7, 2013).
10.24	Guarantee Agreement dated as of August 6, 2012 by Dynex Capital, Inc. in favor of Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 10.24 to Dynex's Current Report on Form 8-K filed August 8, 2012).
10.25*	Form of Restricted Stock Agreement for Non-Employee Directors under the Dynex Capital, Inc. 2009 Stock and Incentive Plan (incorporated herein by reference to Exhibit 10.25 to Dynex's Annual Report on Form 10-K for the year ended December 31, 2012).
10.26*	Amendment to Restricted Stock Agreement for Byron L. Boston under the Dynex Capital, Inc. 2009 Stock and Incentive Plan, effective January 1, 2013 (incorporated herein by reference to Exhibit 10.26 to Dynex's Quarterly Report on Form 10-Q filed May 10, 2013).
10.27	Underwriting Agreement, dated April 11, 2013, by and among Dynex Capital, Inc., J.P. Morgan Securities LLC, and Keefe, Bruyette & Woods, Inc. (incorporated herein by reference to Exhibit 1.1 to Dynex's Current Report on Form 8-K filed April 16, 2013).
21.1	List of consolidated entities of Dynex (filed herewith).
23.1	Consent of BDO USA, LLP (filed herewith).
31.1	Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification of principal executive officer and principal financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

<u>Exhibit No.</u>	<u>Description</u>
101	The following materials from Dynex Capital, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2013, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Consolidated Balance Sheets (unaudited), (ii) Consolidated Statements of Net Income (unaudited), (iii) Consolidated Statements of Comprehensive Income (unaudited), (iv) Consolidated Statements of Shareholder's Equity (unaudited), (v) Consolidated Statements of Cash Flows (unaudited), and (vi) Notes to Consolidated Financial Statements (unaudited).

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\* Denotes management contract.

(b) Exhibits: See Item 15(a)(3) above.

(c) Financial Statement Schedules: None.

## SIGNATURES

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

**DYNEX CAPITAL, INC.**  
(Registrant)

March 4, 2014

/s/ Stephen J. Benedetti

Stephen J. Benedetti, Executive Vice President, Chief Operating Officer and Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<b><u>Signature</u></b>	<b><u>Title</u></b>	<b><u>Date</u></b>
<u>/s/ Thomas B. Akin</u> Thomas B. Akin	Executive Chairman and Director	March 4, 2014
<u>/s/ Byron L. Boston</u> Byron L. Boston	Chief Executive Officer, President, Co-Chief Investment Officer, and Director (Principal Executive Officer)	March 4, 2014
<u>/s/ Stephen J. Benedetti</u> Stephen J. Benedetti	Executive Vice President, Chief Operating Officer and Chief Financial Officer (Principal Financial Officer)	March 4, 2014
<u>/s/ Jeffrey L. Childress</u> Jeffrey L. Childress	Vice President and Controller (Principal Accounting Officer)	March 4, 2014
<u>/s/ Michael R. Hughes</u> Michael R. Hughes	Director	March 4, 2014
<u>/s/ Barry A. Igdaloff</u> Barry A. Igdaloff	Director	March 4, 2014
<u>/s/ Valerie A. Mosley</u> Valerie A. Mosley	Director	March 4, 2014
<u>/s/ Robert A. Salcetti</u> Robert A. Salcetti	Director	March 4, 2014
<u>/s/ James C. Wheat, III</u> James C. Wheat, III	Director	March 4, 2014

**DYNEX CAPITAL, INC.**  
**CONSOLIDATED FINANCIAL STATEMENTS AND**  
**REPORTS OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**  
**For Inclusion in Form 10-K**  
**Annual Report Filed with**  
**Securities and Exchange Commission**  
**December 31, 2013**

**DYNEX CAPITAL, INC.**  
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## Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders  
Dynex Capital, Inc.  
Glen Allen, Virginia

We have audited the accompanying consolidated balance sheets of Dynex Capital, Inc. (Dynex) as of December 31, 2013 and 2012 and the related consolidated statements of income and comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Dynex at December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Dynex's internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 4, 2014 expressed an unqualified opinion thereon.

BDO USA, LLP

Richmond, Virginia  
March 4, 2014



## Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders  
Dynex Capital, Inc.  
Glen Allen, Virginia

We have audited Dynex Capital, Inc.'s (Dynex) internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Dynex's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A, Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, Dynex maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Dynex as of December 31, 2013 and 2012, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2013 and our report dated March 4, 2014 expressed an unqualified opinion thereon.

BDO USA, LLP

Richmond, Virginia  
March 4, 2014

**DYNEX CAPITAL, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(amounts in thousands except share data)

	<u>December 31, 2013</u>	<u>December 31, 2012</u>
<b>ASSETS</b>		
Mortgage-backed securities, at fair value (including pledged of \$3,873,584 and \$3,967,134, respectively)	\$ 4,018,161	\$ 4,103,981
Securitized mortgage loans, net	54,748	70,823
Other investments, net	675	858
	<u>4,073,584</u>	<u>4,175,662</u>
Cash and cash equivalents	69,330	55,809
Restricted cash	13,385	—
Derivative assets	18,488	—
Principal receivable on investments	12,999	17,008
Accrued interest receivable	21,703	23,073
Other assets, net	7,648	8,677
Total assets	<u>\$ 4,217,137</u>	<u>\$ 4,280,229</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Repurchase agreements	\$ 3,580,754	\$ 3,564,128
Payable for unsettled mortgage-backed securities	10,358	—
Non-recourse collateralized financing	12,914	30,504
Derivative liabilities	6,681	42,537
Accrued interest payable	2,548	2,895
Accrued dividends payable	16,601	16,770
Other liabilities	1,405	6,685
Total liabilities	<u>3,631,261</u>	<u>3,663,519</u>
Commitments and Contingencies (Note 12)		
<b>Shareholders' equity:</b>		
Preferred stock, par value \$.01 per share, 8.5% Series A Cumulative Redeemable; 8,000,000 shares authorized; 2,300,000 shares issued and outstanding (\$57,500 aggregate liquidation preference)	\$ 55,407	\$ 55,407
Preferred stock, par value \$.01 per share, 7.625% Series B Cumulative Redeemable; 7,000,000 shares authorized; 2,250,000 shares issued and outstanding(\$56,250 aggregate liquidation preference)	54,251	—
Common stock, par value \$.01 per share, 200,000,000 shares authorized; 54,310,484 and 54,268,915 shares issued and outstanding, respectively	543	543
Additional paid-in capital	761,550	759,214
Accumulated other comprehensive (loss) income	(33,816)	52,511
Accumulated deficit	<u>(252,059)</u>	<u>(250,965)</u>
Total shareholders' equity	<u>585,876</u>	<u>616,710</u>
Total liabilities and shareholders' equity	<u>\$ 4,217,137</u>	<u>\$ 4,280,229</u>

See notes to consolidated financial statements.

**DYNEX CAPITAL, INC.**  
**CONSOLIDATED STATEMENTS OF NET INCOME**  
(amounts in thousands except per share data)

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Interest income:			
Mortgage-backed securities	\$ 123,629	\$ 107,728	\$ 75,639
Securitized mortgage loans	3,436	5,395	7,615
Other investments	67	425	123
	127,132	113,548	83,377
Interest expense:			
Repurchase agreements	38,102	33,789	19,569
Non-recourse collateralized financing	926	1,358	4,513
	39,028	35,147	24,082
Net interest income	88,104	78,401	59,295
Provision for loan losses	(261)	(192)	(871)
Net interest income after provision for loan losses	87,843	78,209	58,424
Litigation settlement and related costs	—	—	(8,240)
Loss on non-recourse collateralized financing	—	—	(1,970)
Loss on derivative instruments, net	(10,076)	(908)	(2,825)
Gain on sale of investments, net	3,354	8,461	2,096
Fair value adjustments, net	(652)	735	2,149
Other income, net	658	281	134
General and administrative expenses:			
Compensation and benefits	(7,004)	(7,635)	(5,321)
Other general and administrative	(6,054)	(5,101)	(4,635)
Net income	\$ 68,069	\$ 74,042	\$ 39,812
Preferred stock dividends	(7,902)	(2,036)	—
Net income to common shareholders	\$ 60,167	\$ 72,006	\$ 39,812
Weighted average common shares:			
Basic	54,648	53,146	38,580
Diluted	54,648	53,146	38,581
Net income per common share:			
Basic	\$ 1.10	\$ 1.35	\$ 1.03
Diluted	\$ 1.10	\$ 1.35	\$ 1.03

See notes to consolidated financial statements.

**DYNEX CAPITAL, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
*(amounts in thousands)*

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Net income	\$ 68,069	\$ 74,042	\$ 39,812
Other comprehensive income (loss):			
Change in fair value of available-for-sale investments	(113,343)	75,377	11,408
Reclassification adjustment from accumulated other comprehensive income for gain on sale of investments, net	(3,354)	(5,319)	(2,096)
Change in fair value of cash flow hedges	16,381	(28,740)	(34,228)
Reclassification adjustment from accumulated other comprehensive income for cash flow hedges (including de-designated hedges)	13,989	14,448	11,604
Other comprehensive (loss) income	(86,327)	55,766	(13,312)
Comprehensive (loss) income	(18,258)	129,808	26,500
Dividends declared on preferred stock	(7,902)	(2,036)	—
Comprehensive (loss) income to common shareholders	\$ (26,160)	\$ 127,772	\$ 26,500

*See notes to consolidated financial statements.*

**DYNEX CAPITAL, INC.**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
(amounts in thousands)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
<b>Balance as of January 1, 2011</b>	\$ —	\$ 303	\$ 538,304	\$ 10,057	\$ (256,307)	\$ 292,357
Common stock issuance	—	97	95,327	—	—	95,424
Granting and vesting of restricted stock	—	4	1,194	—	—	1,198
Capitalized expenses from stock issuances	—	—	(142)	—	—	(142)
Net income	—	—	—	—	39,812	39,812
Dividends on common stock	—	—	—	—	(43,988)	(43,988)
Other comprehensive loss	—	—	—	(13,312)	—	(13,312)
<b>Balance as of December 31, 2011</b>	—	<b>404</b>	<b>634,683</b>	<b>(3,255)</b>	<b>(260,483)</b>	<b>371,349</b>
Stock issuance	55,689	138	123,859	—	—	179,686
Granting and vesting of restricted stock	—	2	1,721	—	—	1,723
Capitalized expenses from stock issuances	(282)	—	(129)	—	—	(411)
Common stock repurchased	—	(1)	(920)	—	—	(921)
Net income	—	—	—	—	74,042	74,042
Dividends on preferred stock	—	—	—	—	(2,036)	(2,036)
Dividends on common stock	—	—	—	—	(62,488)	(62,488)
Other comprehensive income	—	—	—	55,766	—	55,766
<b>Balance as of December 31, 2012</b>	<b>55,407</b>	<b>543</b>	<b>759,214</b>	<b>52,511</b>	<b>(250,965)</b>	<b>616,710</b>
Stock issuance	54,459	7	7,548	—	—	62,014
Granting and vesting of restricted stock	—	3	2,376	—	—	2,379
Capitalized expenses from stock issuances	(208)	—	(119)	—	—	(327)
Common stock repurchased	—	(9)	(6,924)	—	—	(6,933)
Adjustments for tax withholding on share-based compensation	—	(1)	(545)	—	—	(546)
Net income	—	—	—	—	68,069	68,069
Dividends on preferred stock	—	—	—	—	(7,902)	(7,902)
Dividends on common stock	—	—	—	—	(61,261)	(61,261)
Other comprehensive loss	—	—	—	(86,327)	—	(86,327)
<b>Balance as of December 31, 2013</b>	<b>\$ 109,658</b>	<b>\$ 543</b>	<b>\$ 761,550</b>	<b>\$ (33,816)</b>	<b>\$ (252,059)</b>	<b>\$ 585,876</b>

See note to the consolidated financial statements.

**DYNEX CAPITAL, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(amounts in thousands)

	Year Ended December 31,		
	2013	2012	2011
<b>Operating activities:</b>			
Net income	\$ 68,069	\$ 74,042	\$ 39,812
Adjustments to reconcile net income to cash provided by operating activities:			
Decrease (increase) in accrued interest receivable	1,370	(10,464)	(6,504)
(Decrease) increase in accrued interest payable	(347)	730	1,086
Provision for loan losses	261	192	871
Loss on derivative instruments, net	10,076	908	2,825
Gain on sale of investments, net	(3,354)	(8,461)	(2,096)
Loss on non-recourse collateralized financing	—	—	1,970
Fair value adjustments, net	652	(735)	(2,149)
Amortization and depreciation	136,608	90,530	32,505
Stock-based compensation expense	2,314	1,712	783
Net change in other assets and other liabilities	(6,889)	934	1,538
Net cash and cash equivalents provided by operating activities	208,760	149,388	70,641
<b>Investing activities:</b>			
Purchase of investments	(1,419,060)	(2,639,909)	(1,606,819)
Principal payments received on investments	913,210	679,635	468,401
Proceeds from sales of investments	358,090	231,145	184,688
Principal payments received on securitized mortgage loans	15,828	40,830	37,556
Net payments on derivatives not designated as hedges	(39,097)	—	—
Other investing activities	5,891	(2,893)	419
Net cash and cash equivalents used in investing activities	(165,138)	(1,691,192)	(915,755)
<b>Financing activities:</b>			
Borrowings under repurchase agreements, net	16,209	1,470,995	859,610
Deferred borrowing costs paid	—	(825)	—
Principal payments on non-recourse collateralized financing	(17,840)	(40,626)	(15,296)
Cash paid to redeem securitization financing bond	—	—	(23,669)
Increase in restricted cash	(13,346)	—	—
Proceeds from issuance of preferred stock	54,251	55,407	—
Proceeds from issuance of common stock	7,436	123,868	95,282
Cash paid for repurchases of common stock	(6,934)	(921)	—
Payments related to tax withholding for share-based compensation	(545)	—	—
Dividends paid	(69,332)	(59,061)	(40,873)
Net cash and cash equivalents (used in) provided by financing activities	(30,101)	1,548,837	875,054
Net increase in cash and cash equivalents	13,521	7,033	29,940
Cash and cash equivalents at beginning of period	55,809	48,776	18,836
Cash and cash equivalents at end of period	\$ 69,330	\$ 55,809	\$ 48,776
<b>Supplemental Disclosure of Cash Activity:</b>			
Cash paid for interest	\$ 33,517	\$ 34,035	\$ 22,110

See notes to consolidated financial statements.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**DYNEX CAPITAL, INC.**

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

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Organization**

Dynex Capital, Inc., ("Company") was incorporated in the Commonwealth of Virginia on December 18, 1987 and commenced operations in February 1988. The Company primarily earns income from investing on a leveraged basis in mortgage-backed securities ("MBS") that are issued or guaranteed by the U.S. Government or U.S. Government sponsored agencies ("Agency MBS") and MBS issued by others ("non-Agency MBS").

**Basis of Presentation**

The accompanying consolidated financial statements of Dynex Capital, Inc. and its qualified real estate investment trust ("REIT") subsidiaries and its taxable REIT subsidiary (together, "Dynex" or the "Company") have been prepared in accordance with the generally accepted accounting principles in the United States ("GAAP") and the instructions to the Annual Report on Form 10-K and Article 3 of Regulation S-X promulgated by the Securities and Exchange Commission (the "SEC").

**Reclassifications**

Certain items in the prior years' consolidated financial statements have been reclassified to conform to the current year's presentation. The Company's consolidated balance sheet as of December 31, 2012 now presents its Agency and non-Agency mortgage-backed securities as "mortgage-backed securities, at fair value". The Company's consolidated statements of net income for the years ended December 31, 2012 and December 31, 2011 now present interest income from Agency and non-Agency mortgage-backed securities together as "interest income: mortgage-backed securities". In addition, changes in fair value and other activity related to the Company's derivative instruments have been reclassified from "fair value adjustments, net" to "loss on derivative instruments, net". As a result, the respective amounts on the Company's consolidated statements of cash flow for the years ended December 31, 2012 and December 31, 2011 have been changed to reflect this reclassification. These presentation changes have no effect on reported total assets, total liabilities, results of operations, or cash flow activities.

**Consolidation**

The consolidated financial statements include the accounts of the Company, its qualified REIT subsidiaries and its taxable REIT subsidiary. The consolidated financial statements represent the Company's accounts after the elimination of intercompany balances and transactions. The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others and variable interest entities in which it is determined to be the primary beneficiary in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 810-10. The Company follows the equity method of accounting for investments in which it owns greater than a 20% and less than 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 50% of the voting equity. The Company did not have any investments in which it owned less than a 50% interest in the voting equity as of December 31, 2013 or December 31, 2012.

In accordance with ASC Topic 810-10, the Company also consolidates certain trusts through which it has securitized mortgage loans. Additional information regarding the accounting policy for securitized mortgage loans is provided below under "Investments".

**Use of Estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management include but are not limited to fair value

measurements of its investments, allowance for loan losses, other-than-temporary impairments, contingencies, and amortization of premiums and discounts. These items are discussed further below within this note to the consolidated financial statements.

## **Federal Income Taxes**

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). As such, the Company believes that it qualifies as a REIT for federal income tax purposes, and it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders. The Company uses the calendar year for both tax and financial reporting purposes. There may be differences between taxable income and income computed in accordance with GAAP.

## **Mortgage-Backed Securities**

In accordance with ASC Topic 320, the Company has designated the majority of its investments in MBS as available-for-sale ("AFS"), and the remainder is designated as trading. All of the Company's MBS are recorded at their fair value on its consolidated balance sheet. Changes in fair value for the Company's AFS securities are reported in other comprehensive income ("OCI") until the security is collected, disposed of, or determined to be other than temporarily impaired. Although the Company generally intends to hold its AFS securities until maturity, it may, from time to time, sell any of these securities as part of the overall management of its business. Upon the sale of an AFS security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income ("AOCI") into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method. Changes in the fair value of MBS designated as trading are recognized in net income within "fair value adjustments, net". Gains and losses realized upon the sale, impairment, or other disposal of a trading security are also recognized within "fair value adjustments, net".

The Company's MBS pledged as collateral against repurchase agreements and derivative instruments are included in MBS on the consolidated balance sheets with the fair value of the MBS pledged disclosed parenthetically.

Interest Income, Premium Amortization, and Discount Accretion. Interest income on MBS is accrued based on the outstanding principal balance (or notional balance in the case of interest-only, or "IO", securities) and their contractual terms. Premiums and discounts on Agency MBS as well as any non-Agency MBS rated AA and higher at the time of purchase are amortized into interest income over the expected life of such securities using the effective yield method and adjustments to premium amortization are made for actual prepayment activity as well as changes in projected future cash flows in accordance with ASC Topic 310-20. The Company's projections of future cash flows are based on input and analysis received from external sources and internal models, and includes assumptions about the amount and timing of credit losses, loan prepayment rates, fluctuations in interest rates, and other factors. On at least a quarterly basis, the Company reviews and makes any necessary adjustments to its cash flow projections and updates the yield recognized on these assets.

The Company has purchased non-Agency MBS rated less than 'AA' by at least one national rating agency at discounts to their par value, and management does not believe these discounts to be substantial. The Company records the discount accretion into income over the security's expected life, which reflects management's estimate of the security's projected cash flows in accordance with ASC Topic 325-40. Future changes in projected cash flows or differences arising between projected cash flows and actual cash flows received may result in a prospective change in the effective yield on those securities.

The accrual of interest on MBS is discontinued when, in the opinion of management, it is probable that all amounts contractually due will not be collected, and in certain instances, as a result of an other-than-temporary impairment analysis ("OTTI", see discussion below). All interest accrued but not collected for investments that are placed on a non-accrual status or are charged-off is reversed against interest income. Interest on these investments is accounted for on the cash-basis or cost-recovery method until the affected investment or investments qualify for return to accrual status. Investments are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Determination of MBS Fair Value. In accordance with ASC Topic 820, the Company determines the fair value for the majority of its MBS based upon prices obtained from third-party pricing services and broker quotes. The remainder of the Company's MBS are valued by discounting the estimated future cash flows derived from cash flow models that utilize information such as the security's coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future



interest rates, expected losses, and credit enhancements as well as certain other relevant information. The Company's application of ASC Topic 820 guidance is discussed further in Note 9.

**Other-than-Temporary Impairment.** The Company evaluates all MBS in its investment portfolio for other-than-temporary impairments ("OTTI") by comparing the amortized cost of each security in an unrealized loss position against the present value of expected future cash flows of the security. If there has been a significant adverse change in the cash flow expectations for a security resulting in its amortized cost becoming greater than the present value of its expected future cash flows, an other-than-temporary credit impairment has occurred. If the Company does not intend to sell and is not more likely than not required to sell the security, the credit loss is recognized in earnings and the balance of the unrealized loss is recognized in other comprehensive income (loss). If the Company intends to sell the security or will be more likely than not required to sell the security, the full unrealized loss is recognized in earnings.

In periods after the recognition of an OTTI for MBS, the Company accounts for the other-than-temporarily impaired MBS as if the MBS had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For MBS for which OTTIs were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted into interest income using the effective interest method. The Company continues to estimate the present value of cash flows expected to be collected over the life of the MBS. If upon subsequent evaluation, there is an increase in the cash flows expected to be collected or if actual cash flows are greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with ASC Topic 310-30. Please see Note 3 for additional information related to the Company's evaluation for OTTI.

### **Securitized Mortgage Loans**

Securitized mortgage loans consist of loans pledged to support the repayment of securitization financing bonds issued by the Company. The associated securitization financing bonds are treated as debt of the Company and are presented as a portion of "non-recourse collateralized financing" on the consolidated balance sheet. In accordance with ASC Topic 310-10, the Company's securitized mortgage loans are reported at amortized cost. Securitized mortgage loans can only be sold subject to the lien of the respective securitization financing indenture. An allowance has been established for currently existing and probable losses on such loans in accordance with ASC Topic 310-10.

### **Other Investments**

Other investments primarily consist of unsecuritized mortgage loans owned by the Company which are accounted for using the cost method in accordance with ASC Topic 325-20. Management evaluates the need for an allowance for loan losses on these unsecuritized mortgage loans in accordance with ASC Topic 310-10 on at least a quarterly basis.

### **Cash and Cash Equivalents**

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

### **Restricted Cash**

Restricted cash consists of cash the Company has pledged to cover initial and variation margin with its counterparties.

### **Repurchase Agreements**

Repurchase agreements are treated as financings in accordance with the provision of ASC Topic 860 under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. Most of the Company's repurchase

agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

## **Derivative Instruments**

The Company accounts for its derivative instruments in accordance with ASC Topic 815. ASC Topic 815 requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value.

Effective June 30, 2013, the Company discontinued cash flow hedge accounting for derivative instruments which had previously been accounted for as cash flow hedges under ASC Topic 815. Activity up to and including June 30, 2013 for those agreements previously designated as cash flow hedges was recorded in accordance with cash flow hedge accounting as prescribed by ASC Topic 815, which states that the effective portion of the hedge relationship on an instrument designated as a cash flow hedge is reported in the current period's other comprehensive income while the ineffective portion is immediately reported in the current period's consolidated statement of net income. The balance remaining in AOCI related to the de-designated cash flow hedges is being recognized in the Company's consolidated statement of net income as a portion of "interest expense" over the remaining life of the interest rate swap agreements. Subsequent to June 30, 2013, changes in the fair value of the Company's derivative instruments, plus periodic settlements, are recorded in the Company's consolidated statement of net income as a portion of "loss on derivative instruments, net".

The Company has Eurodollar futures, which are valued based on closing exchange prices. Variation margin is exchanged daily to settle any changes in the value of the Eurodollar futures. Gains and losses associated with purchases and short sales of futures contracts are reported in "(loss) gain on derivative instruments, net" in our consolidated statements of net income.

The Company has elected to use the portfolio exception in ASC 820-10-35-18D with respect to measuring counterparty credit risk for derivative instruments. The Company manages credit risk for its derivative positions on a counterparty-by-counterparty basis (that is, on the basis of its net portfolio exposure with each counterparty), consistent with its risk management strategy for such transactions. The Company manages credit risk by considering indicators of risk such as credit ratings, and by negotiating terms in its ISDA master netting arrangements and, if applicable, any associated Credit Support Annex documentation, with each individual counterparty. Since the effective date of ASC 820, management has monitored and measured credit risk and calculated credit valuation adjustments for its derivative transactions on the basis of its relationships at the counterparty portfolio level. Management receives reports from an independent third-party valuation specialist on a monthly basis providing the credit valuation adjustments at the counterparty portfolio level for purposes of reviewing and managing its credit risk exposures. Since the portfolio exception applies only to the fair value measurement and not to financial statement presentation, the portfolio-level adjustments are then allocated in a reasonable and consistent manner each period to the individual assets or liabilities that make up the group, in accordance with other applicable accounting guidance and the Company's accounting policy elections.

Although MBS have characteristics that meet the definition of a derivative instrument, ASC 815 specifically excludes these instruments from its scope because they are accounted for as debt securities under ASC 320.

## **Stock-Based Compensation**

Pursuant to the Company's 2009 Stock and Incentive Plan ("SIP"), the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights ("SARs"), dividend equivalent rights, performance shares, and restricted stock units. Currently, the Company's stock options and restricted stock issued under this plan may be settled only in shares of its common stock, and therefore are treated as equity awards with their fair value measured at the grant date as required by ASC Topic 718. Outstanding SARs issued by the Company may be settled only in cash, and therefore have been treated as liability awards with their fair value estimated at the grant date and remeasured at the end of each reporting period using the Black-Scholes option valuation model as required by ASC Topic 718. Please see Note 10 for additional disclosures regarding the Company's SIP.

## Contingencies

In the normal course of business, there are various lawsuits, claims, and other contingencies pending against the Company. We evaluate whether to establish provisions for estimated losses from those matters in accordance with ASC Topic 450, which states that a liability is recognized for a contingent loss when: (a) the underlying causal event has occurred prior to the balance sheet date; (b) it is probable that a loss has been incurred; and (c) there is a reasonable basis for estimating that loss. A liability is not recognized for a contingent loss when it is only possible or remotely possible that a loss has been incurred, however, possible contingent losses shall be disclosed. Please refer to Note 12 for details on the most significant matters currently pending.

## Recent Accounting Pronouncements

In July 2013, the FASB issued ASU 2013-10, *Derivatives and Hedging (Topic 815), Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes* (a consensus of the FASB Emerging Issues Task Force) ("ASU 2013-10"). The new guidance permits the use of the Federal Funds Effective Swap Rate as a benchmark interest rate for hedge accounting purposes and removes certain restrictions on being able to apply hedge accounting for similar hedges using different benchmark interest rates. ASU 2013-10 is effective prospectively for qualifying new or re-designated hedging relationships entered into on or after July 17, 2013. The adoption of this ASU does not have an impact on our derivatives and will not have a material impact on the Company's consolidated financial statements.

In June 2013, the FASB issued ASU 2013-08, *Financial Services - Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements* ("ASU 2013-08"). In general, the amendments of this ASU: (i) revise the definition of an investment company; (ii) require an investment company to measure non-controlling ownership interests in other investment companies at fair value rather than using the equity method of accounting; and (iii) require information to be disclosed concerning the status of the entity and any financial support provided, or contractually required to be provided, by the investment company to its investees. ASU 2013-08 is effective for interim and annual periods that begin after December 15, 2013 and early application is prohibited. As the FASB has decided to retain the current U.S. GAAP scope exception from investment company accounting and financial reporting for real estate investment trusts, the adoption of this ASU will not have a material impact on the Company's consolidated financial statements.

## NOTE 2 – NET INCOME PER COMMON SHARE

Net income per common share is presented on both a basic and diluted basis. Diluted net income per common share assumes the exercise of stock options, if any were outstanding during the period presented, using the treasury stock method. Because the Company's Series A Cumulative Redeemable Preferred Stock and Series B Cumulative Redeemable Preferred Stock are redeemable at the Company's option for cash only, and may convert into shares of common stock only upon a change of control of the Company, the effect of those shares is excluded from the calculation of diluted net income per common share.

Holders of unvested shares of our issued and outstanding restricted common stock are eligible to receive non-forfeitable dividends. As such, these unvested shares are considered participating securities as per ASC 260-10 and therefore are included in the computation of basic net income per share using the two-class method. Upon vesting, restrictions on transfer expire on each share of restricted stock, and each such share of restricted is converted to one equal share of common stock.

The following table presents the calculation of the numerator and denominator for both basic and diluted net income per common share for the periods indicated:

For the Year Ended December 31,						
	2013		2012		2011	
	Net Income	Weighted-Average Common Shares	Net Income	Weighted- Average Common Shares	Net Income	Weighted- Average Common Shares
Net income	\$ 68,069		\$ 74,042		\$ 39,812	
Preferred stock dividends	(7,902)		(2,036)		—	
Net income to common shareholders	60,167	54,647,643	72,006	53,146,416	39,812	38,579,780
Effect of dilutive stock options	—	—	—	—	—	799
Diluted	\$ 60,167	54,647,643	\$ 72,006	53,146,416	\$ 39,812	38,580,579
Net income per common share:						
Basic		\$ 1.10		\$ 1.35		\$ 1.03
Diluted <sup>(1)</sup>		\$ 1.10		\$ 1.35		\$ 1.03
(1) For the years ended December 31, 2012 and 2011, the calculation of diluted net income per common share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.						

### NOTE 3 – MORTGAGE-BACKED SECURITIES

The following table presents the components and weighted average coupon ("WAC") for the portion of the Company's MBS designated as AFS as of December 31, 2013 and December 31, 2012:

	December 31, 2013						
	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC
<b>Agency:</b>							
RMBS	\$ 2,591,568	\$ 154,220	\$ 2,745,788	\$ 6,104	\$ (59,742)	\$ 2,692,150	3.22%
CMBS	273,830	19,061	292,891	10,793	(900)	302,784	5.07%
CMBS IO <sup>(1)</sup>	—	453,766	453,766	9,895	(3,334)	460,327	0.83%
Total Agency AFS:	2,865,398	627,047	3,492,445	26,792	(63,976)	3,455,261	
<b>Non-Agency:</b>							
RMBS	13,845	(338)	13,507	338	(80)	13,765	4.61%
CMBS	375,703	(18,277)	357,426	15,366	(3,511)	369,281	5.10%
CMBS IO <sup>(1)</sup>	—	150,518	150,518	2,618	(1,999)	151,137	0.66%
Total non-Agency AFS:	389,548	131,903	521,451	18,322	(5,590)	534,183	
<b>Total AFS securities</b>	<b>\$ 3,254,946</b>	<b>\$ 758,950</b>	<b>\$ 4,013,896</b>	<b>\$ 45,114</b>	<b>\$ (69,566)</b>	<b>\$ 3,989,444</b>	

(1) The notional balance for Agency CMBS IO and non-Agency CMBS IO is \$10,160,502 and \$4,274,957, respectively, as of December 31, 2013.

December 31, 2012							
	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC
<b>Agency:</b>							
RMBS	\$ 2,425,826	\$ 137,168	\$ 2,562,994	\$ 19,477	\$ (11,134)	\$ 2,571,337	3.67%
CMBS	280,602	21,907	302,509	21,570	(6)	324,073	5.19%
CMBS IO <sup>(1)</sup>	—	550,171	550,171	18,218	(1,209)	567,180	0.95%
Total Agency AFS:	2,706,428	709,246	3,415,674	59,265	(12,349)	3,462,590	
<b>Non-Agency:</b>							
RMBS	11,411	(781)	10,630	606	(198)	11,038	4.28%
CMBS	463,747	(17,313)	446,434	39,944	(36)	486,342	5.31%
CMBS IO <sup>(1)</sup>	—	108,928	108,928	5,054	(40)	113,942	0.86%
Total non-Agency AFS:	475,158	90,834	565,992	45,604	(274)	611,322	
<b>Total AFS securities</b>	<b>\$ 3,181,586</b>	<b>\$ 800,080</b>	<b>\$ 3,981,666</b>	<b>\$ 104,869</b>	<b>\$ (12,623)</b>	<b>\$ 4,073,912</b>	

(1) The notional balance for the Agency CMBS IO and non-Agency CMBS IO is \$10,059,495 and \$2,393,614, respectively, as of December 31, 2012.

The Company has investments in additional Agency CMBS not included in the tables above that are designated as trading securities by the Company with fair values of \$28,717 and \$30,069 as of December 31, 2013 and December 31, 2012, respectively. Changes in the fair value of these Agency CMBS are recognized each reporting period within "fair value adjustments, net" in the Company's consolidated statements of net income. As of December 31, 2013 and December 31, 2012, the amortized cost of these Agency CMBS designated as trading securities was \$26,920 and \$27,535, respectively. The Company recognized a net unrealized loss for the year ended December 31, 2013 of \$(652) compared to a net unrealized gain of \$735 for the year ended December 31, 2012, respectively, related to changes in fair value.

The following table presents certain information for those Agency MBS in an unrealized loss position as of December 31, 2013 and December 31, 2012:

	December 31, 2013			December 31, 2012		
	Fair Value	Gross Unrealized Losses	# of Securities	Fair Value	Gross Unrealized Losses	# of Securities
<b>Continuous unrealized loss position for less than 12 months:</b>						
Agency MBS	\$ 1,912,937	\$ (43,543)	150	\$ 1,026,277	\$ (6,552)	83
Non-Agency MBS	162,558	(5,435)	39	13,877	(76)	3
<b>Continuous unrealized loss position for 12 months or longer:</b>						
Agency MBS	\$ 670,402	\$ (20,433)	67	\$ 271,719	\$ (5,797)	34
Non-Agency MBS	6,310	(155)	6	2,701	(198)	8

Because the principal and interest related to Agency MBS are guaranteed by the government-sponsored entities Fannie Mae and Freddie Mac who have the implicit guarantee of the U.S. government, the Company does not consider any of the unrealized losses on its Agency MBS to be credit related. Although the unrealized losses are not credit related, the Company assesses its ability and intent to hold any Agency MBS with an unrealized loss until the recovery in its value. This assessment is based on the amount of the unrealized loss and significance of the related investment as well as the Company's current leverage and anticipated

liquidity. Based on this analysis, the Company has determined that the unrealized losses on its Agency MBS as of December 31, 2013 and December 31, 2012 were temporary.

The Company also reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an other-than-temporary impairment. The evaluation includes a review of the credit ratings of these non-Agency MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows which include projected losses. The Company performed this evaluation for the non-Agency MBS in an unrealized loss position and has determined that there have not been any adverse changes in the timing or amount of estimated future cash flows that necessitate a recognition of other-than-temporary impairment amounts as of December 31, 2013 or December 31, 2012.

#### NOTE 4 – SECURITIZED MORTGAGE LOANS, NET

The Company's securitized mortgage loans are pledged as collateral for its associated securitization financing bonds, which are discussed further in Note 7. The following table summarizes the components of securitized mortgage loans, net of allowance for loan losses as of December 31, 2013 and December 31, 2012:

	December 31, 2013			December 31, 2012		
	Commercial	Single-family	Total	Commercial	Single-family	Total
Principal/par value <sup>(1)</sup>	\$ 21,442	\$ 34,191	\$ 55,633	\$ 30,576	\$ 41,337	\$ 71,913
Unamortized (discount) premium	(1,126)	498	(628)	(1,267)	616	(651)
Amortized cost	20,316	34,689	55,005	29,309	41,953	71,262
Allowance for loan losses	(102)	(155)	(257)	(150)	(289)	(439)
	<u>\$ 20,214</u>	<u>\$ 34,534</u>	<u>\$ 54,748</u>	<u>\$ 29,159</u>	<u>\$ 41,664</u>	<u>\$ 70,823</u>

*(1) Includes funds held by trustees.*

The following table presents a summary of the changes in the carrying value of the Company's securitized mortgage loans, net for the year ended December 31, 2013:

	For the Year Ended December 31, 2013		
	Commercial	Single-Family	Total
Balance beginning of the period	\$ 29,159	\$ 41,664	\$ 70,823
Principal repayments	(9,134)	(7,146)	(16,280)
Accretion (amortization) of discount (premium)	141	(118)	23
(Recoveries) charge-offs, net	(8)	451	443
Provision for loan losses	56	(317)	(261)
Balance end of period	<u>\$ 20,214</u>	<u>\$ 34,534</u>	<u>\$ 54,748</u>

The Company's securitized commercial mortgage loans were originated principally in 1996 and 1997 and are collateralized by first deeds of trust on income producing properties and are evaluated individually for impairment when the debt service coverage ratio on the mortgage loan is less than 1:1 or when the mortgage loan is delinquent. Commercial mortgage loans not evaluated for individual impairment are evaluated for a general allowance. As of December 31, 2013 and December 31, 2012, the loan-to-value ratio based on original appraisal was 55% and 48%, respectively. There were no securitized commercial mortgage loans identified as seriously delinquent (60 or more days past due) or on nonaccrual status on the Company's consolidated balance sheets as of December 31, 2013 or as of December 31, 2012.

The Company's securitized single-family mortgage loans are secured by first deeds of trust on residential real estate and were originated principally from 1992 to 1997. Single-family mortgage loans are considered homogeneous and are evaluated on a pool basis for a general allowance. As of December 31, 2013 and December 31, 2012, the current loan-to-value ratio based on

original appraisal was approximately 41% and 43%, respectively. The unpaid principal balance of the Company's securitized single-family mortgage loans identified as seriously delinquent as of December 31, 2013 is \$2,758 compared to \$3,380 as of December 31, 2012. The Company continues accruing interest on any seriously delinquent securitized single-family mortgage loan so long as the primary servicer continues to advance the interest and/or principal due on the loan.

The Company considers various factors in determining its specific and general allowance requirements, including whether a loan is delinquent, the Company's historical experience with similar types of loans, historical cure rates of delinquent loans, and historical and anticipated loss severity of the mortgage loans as they are liquidated. The factors may differ by mortgage loan type (e.g., single-family versus commercial) and collateral type (e.g., multifamily versus office property). The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience.

#### NOTE 5 – REPURCHASE AGREEMENTS

The following tables present the components of the Company's repurchase agreements as of December 31, 2013 and December 31, 2012 by the fair value and type of securities pledged as collateral to the repurchase agreements:

Collateral Type	December 31, 2013		
	Balance	Weighted Average Rate	Fair Value of Collateral Pledged
Agency RMBS	\$ 2,522,503	0.42%	2,598,158
Agency CMBS	246,849	0.39%	306,318
Agency CMBS IOs	369,948	1.16%	449,072
Non-Agency RMBS	10,569	1.80%	12,746
Non-Agency CMBS	303,674	1.27%	367,859
Non-Agency CMBS IO	106,803	1.27%	136,227
Securitization financing bonds	20,651	1.59%	19,686
Deferred costs	(243)	n/a	n/a
	<u>\$ 3,580,754</u>	<u>0.61%</u>	<u>\$ 3,890,066</u>

Collateral Type	December 31, 2012		
	Balance	Weighted Average Rate	Fair Value of Collateral Pledged
Agency RMBS	\$ 2,365,982	0.48%	\$ 2,458,200
Agency CMBS	248,771	0.47%	291,445
Agency CMBS IOs	443,540	1.22%	565,494
Non-Agency RMBS	7,808	1.84%	9,634
Non-Agency CMBS	382,352	1.34%	465,306
Non-Agency CMBS IOs	88,221	1.46%	113,942
Securitization financing bonds	28,113	1.64%	31,483
Deferred costs	(659)	n/a	n/a
	<u>\$ 3,564,128</u>	<u>0.70%</u>	<u>\$ 3,935,504</u>

The combined weighted average original term to maturity for the Company's repurchase agreements increased to 114 days as of December 31, 2013 from 67 days as of December 31, 2012. The Company has been able to extend the average term to maturity of its repurchase agreements due to discontinuing cash flow hedge accounting effective June 30, 2013. The following table provides a summary of the original maturities as of December 31, 2013 and December 31, 2012:

Original Maturity	December 31, 2013	December 31, 2012
30 days or less	\$ 206,112	\$ 622,957
31 to 60 days	492,145	1,263,105
61 to 90 days	665,020	298,660
91 to 120 days	783,371	1,092,681
121 to 190 days	1,434,349	287,384
	<u>\$ 3,580,997</u>	<u>\$ 3,564,787</u>

As of December 31, 2013, the Company had approximately \$91,769 of its shareholders' equity at risk (defined as the excess of collateral pledged over the borrowing outstanding) with Wells Fargo Bank National Association together with its affiliate Wells Fargo Securities, LLC. The borrowings outstanding with that counterparty and its affiliates as of December 31, 2013 were \$371,753 with a weighted average borrowing rate of 1.21%. Of the amount outstanding with this counterparty and its affiliate, \$171,769 is under a two-year repurchase facility with Wells Fargo Bank National Association. The facility provides an aggregate maximum borrowing capacity of \$250,000 and matures on August 6, 2015, subject to early termination provisions contained in the master repurchase agreement. The facility is collateralized primarily by CMBS IO, and its weighted average borrowing rate as of December 31, 2013 was 1.43%. Shareholders' equity at risk did not exceed 10% for any of the Company's other counterparties.

As of December 31, 2013, the Company had repurchase agreement amounts outstanding with 22 of its 31 available counterparties. The Company's counterparties, as set forth in the master repurchase agreement with the counterparty, require the Company to comply with various customary operating and financial covenants, including, but not limited to, minimum net worth, maximum declines in net worth in a given period, and maximum leverage requirements as well as maintaining the Company's REIT status. In addition, some of the agreements contain cross default features, whereby default under an agreement with one lender simultaneously causes default under agreements with other lenders. To the extent that the Company fails to comply with the covenants contained in these financing agreements or is otherwise found to be in default under the terms of such agreements, the counterparty has the right to accelerate amounts due under the master repurchase agreement. The Company was in compliance with all covenants as of December 31, 2013.

#### NOTE 6 – DERIVATIVES

The Company utilizes a variety of derivative instruments to economically hedge a portion of its exposure to market risks, primarily interest rate risk. The principal instruments used to hedge these risks are interest rate swaps and Eurodollar futures. The objective of the Company's risk management strategy is to protect the Company's earnings from rising interest rates and to mitigate declines in book value resulting from fluctuations in the fair value of the Company's assets from changing interest rates. The Company seeks to limit its exposure to changes in interest rates but does not seek to eliminate this risk.

Effective June 30, 2013, the Company voluntarily discontinued hedge accounting for interest rate swaps which had previously been accounted for as cash flow hedges under GAAP. The Company discontinued cash flow hedge accounting for its interest rate swap agreements in order to gain greater flexibility in managing the maturities of its repurchase agreement borrowings. In addition, the Company began purchasing Eurodollar futures during the third quarter of 2013. Please refer to Note 1 for additional information related to the Company's accounting policy for its derivative instruments.

The table below summarizes information about the Company's derivative instruments on its consolidated balance sheet as of the dates indicated:



			December 31, 2013	
Type of Derivative Instrument	Accounting Designation	Balance Sheet Location:	Fair Value	Aggregate Notional Amount
Interest rate swaps	Non-hedging	Derivative assets	\$ 18,488	\$ 575,000
Interest rate swaps	Non-hedging		\$ (1,336)	\$ 215,000
Eurodollar futures	Non-hedging		(5,345)	9,000,000
		Derivative liabilities	\$ (6,681)	\$ 9,215,000
			December 31, 2012	
Type of Derivative Instrument	Accounting Designation	Balance Sheet Location:	Fair Value	Aggregate Notional Amount
Interest rate swaps	Hedging		\$ (39,813)	\$ 1,435,000
Interest rate swaps	Non-hedging		(2,724)	27,000
		Derivative liabilities	\$ (42,537)	\$ 1,462,000

The following table summarizes activity related to derivative instruments for the periods indicated:

(amounts in thousands)

	Interest Rate Swaps	Eurodollar Futures
Notional amount as of December 31, 2012:	\$ 1,462,000	\$ —
Additions:	380,000	20,250,000
Settlements, terminations, or expirations:	(1,052,000)	(11,250,000)
Notional amount as of December 31, 2013: <sup>(1)</sup>	\$ 790,000	\$ 9,000,000

(1) The Eurodollar futures notional amount as of December 31, 2013 represents the total notional of the 3-month contracts with expiration dates from 2016 to 2020. The maximum notional outstanding for any future 3-month period does not exceed \$1,175,000.

The following table summarizes the contractual maturities remaining for the Company's outstanding interest rate swap agreements as of December 31, 2013:

Remaining Maturity	Notional Amount: Trading	Weighted-Average Fixed Rate Swapped
37-48 months	185,000	0.92%
49-60 months	15,000	2.17%
61-72 months	385,000	1.58%
73-84 months	25,000	1.61%
109-127 months	180,000	2.13%
	\$ 790,000	1.56%

As of December 31, 2013, three of these agreements with a total notional balance of \$150,000 and a weighted average pay-fixed rate of 2.17% are 10-year forward-starting swaps which will not be effective until 2014.

The tables below summarize the effect of the Company's interest rate derivatives reported in "loss on derivative instruments, net" on the Company's consolidated statements of net income for the periods indicated:

Type of Derivative Instrument	Year Ended December 31,		
	2013	2012	2011
Interest rate swaps	\$ 9,315	\$ (908)	\$ (2,825)
Eurodollar futures	(19,391)	—	—
Loss on derivative instruments, net	\$ (10,076)	\$ (908)	\$ (2,825)

The Company's consolidated balance sheet as of December 31, 2013 has a net unrealized loss in AOCI of \$9,365 which relates to the interest rate swap agreements previously designated as cash flow hedges. This net unrealized loss will be recognized into the Company's consolidated statement of net income as a portion of "interest expense" over the remaining contractual life of the agreements. All forecasted transactions associated with interest rate swap agreements previously designated as cash flow hedges are expected to occur. No amounts have been reclassified to net income in any period in connection with forecasted transactions that are no longer considered probable of occurring. The Company estimates the portion of existing net unrealized loss on discontinued cash flow hedges expected to be reclassified to earnings within the next 12 months is \$6,767. The Company reclassified \$13,989 from AOCI to its consolidated statement of net income for the year ended December 31, 2013, of which \$5,193 related to amortization of the net unrealized loss remaining in AOCI at the time the Company discontinued its cash flow hedge accounting and the remainder related to recognition of interest expense from cash flow hedging transactions in accordance with ASC Topic 815. The Company reclassified \$14,448 and \$11,604 from AOCI to its consolidated statements of net income for the years ended December 31, 2012 and December 31, 2011, respectively, related to cash flow hedging transactions in accordance with ASC Topic 815.

Many of the Company's interest rate swaps were entered into under bilateral agreements which contain various covenants related to the Company's credit risk. Specifically, if the Company defaults on any of its indebtedness, including those circumstances whereby repayment of the indebtedness has not yet been accelerated by the lender, or is declared in default of any of its covenants with any counterparty, then the Company could also be declared in default under the bilateral agreement. Additionally, these agreements allow those counterparties to require settlement of its outstanding derivative transactions if the Company fails to earn GAAP net income excluding derivative gains and losses greater than one dollar as measured on a rolling two quarter basis. These interest rate agreements also contain provisions whereby, if the Company fails to maintain a minimum net amount of shareholders' equity, then the Company may be declared in default on its derivative obligations. The Company was in compliance with all covenants under bilateral agreements on December 31, 2013.

#### NOTE 7 – NON-RECOURSE COLLATERALIZED FINANCING

The Company has one class of its single-family securitization financing bond outstanding as of December 31, 2013 with an estimated weighted average life remaining of 3.1 years. The interest rate on this bond is based on 1-month LIBOR plus 0.30%. The following table summarizes information about the Company's non-recourse collateralized financing as of the dates indicated:

	December 31, 2013		December 31, 2012	
	Balance Outstanding	Value of Collateral	Balance Outstanding	Value of Collateral
Secured by single-family mortgage loans	\$ 13,134	\$ 13,950	\$ 15,974	\$ 17,309
Secured by non-Agency CMBS	—	—	15,000	15,825
Unamortized bond premium	(220)	n/a	(470)	n/a
	\$ 12,914	\$ 13,950	\$ 30,504	\$ 33,134

The following table presents a summary of the changes in the carrying value of the Company's non-recourse collateralized financing for the year ended December 31, 2013:

	Secured by Non-Agency CMBS	Secured by Single-Family Mortgage Loans	Total
Balance, December 31, 2012	\$ 14,807	\$ 15,697	\$ 30,504
Principal repayments	(15,000)	(2,839)	(17,839)
Amortization of bond premium	193	56	249
Balance, December 31, 2013	\$ —	\$ 12,914	\$ 12,914

#### NOTE 8 – OFFSETTING ASSETS AND LIABILITIES

The Company's derivatives and repurchase agreements are subject to underlying agreements with master netting or similar arrangements, which provide for the right of offset in the event of default or in the event of bankruptcy of either party to the transactions. The Company reports its assets and liabilities subject to these arrangements on a gross basis. The following tables present information regarding those assets and liabilities subject to such arrangements as if the Company had presented them on a net basis as of December 31, 2013 and December 31, 2012:

Offsetting of Assets						
	Gross Amount of Recognized Assets	Gross Amount Offset in the Balance Sheet	Net Amount of Assets Presented in the Balance Sheet	Gross Amount Not Offset in the Balance Sheet		Net Amount
				Financial Instruments Received as Collateral	Cash Received as Collateral	
<b>December 31, 2013</b>						
Derivative assets	\$ 18,488	\$ —	\$ 18,488	\$ (193)	\$ (12,141)	\$ 6,154
<b>December 31, 2012:</b>						
Derivative assets	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

Offsetting of Liabilities						
	Gross Amount of Recognized Liabilities	Gross Amount Offset in the Balance Sheet	Net Amount of Liabilities Presented in the Balance Sheet	Gross Amount Not Offset in the Balance Sheet		Net Amount
				Financial Instruments Posted as Collateral	Cash Posted as Collateral	
<b>December 31, 2013</b>						
Derivative liabilities	\$ 6,681	\$ —	\$ 6,681	\$ (1,299)	\$ (5,382)	\$ —
Repurchase agreements	3,580,754	—	3,580,754	(3,580,754)	—	—
	\$ 3,587,435	\$ —	\$ 3,587,435	\$ (3,582,053)	\$ (5,382)	\$ —
<b>December 31, 2012:</b>						
Derivative liabilities	\$ 42,537	\$ —	\$ 42,537	\$ (42,499)	\$ (38)	\$ —
Repurchase agreements	3,564,128	—	3,564,128	(3,564,128)	—	—
	\$ 3,606,665	\$ —	\$ 3,606,665	\$ (3,606,627)	\$ (38)	\$ —

(1) Amount disclosed for collateral received by or posted to the same counterparty include cash and the fair value of MBS up to and not exceeding the net amount of the asset or liability presented in the balance sheet. The fair value of the actual collateral received by or posted to the same counterparty may exceed the amounts presented.

## NOTE 9 – FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and also requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability. ASC Topic 820 established a valuation hierarchy of three levels as follows:

- Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities as of the measurement date. The fair value measurement of the Company's Eurodollar futures contracts are included in this category.
- Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs either directly observable or indirectly observable through correlation with market data at the measurement date and for the duration of the instrument's anticipated life. The Company's assets and liabilities measured at fair value that are generally included in this category are Agency MBS, certain non-Agency MBS, and interest rate swaps.
- Level 3 – Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management's best estimate of how market participants would price the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model. The Company's assets and liabilities measured at fair value that are generally included in this category are certain non-Agency MBS.

The following table presents the fair value of the Company's assets and liabilities, segregated by the hierarchy level of the fair value estimate, that are measured at fair value on a recurring basis as of the dates indicated:

		December 31, 2013			
		Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
Assets:					
Mortgage-backed securities	\$	4,018,161	\$ —	\$ 3,944,681	\$ 73,480
Derivative assets		18,488	—	18,488	—
Total assets carried at fair value	\$	4,036,649	\$ —	\$ 3,963,169	\$ 73,480
Liabilities:					
Derivative liabilities	\$	6,681	\$ 5,345	\$ 1,336	\$ —
Total liabilities carried at fair value	\$	6,681	\$ 5,345	\$ 1,336	\$ —

December 31, 2012				
	Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
Assets:				
Mortgage-backed securities	\$ 4,103,981	\$ —	\$ 3,998,761	\$ 105,220
Other investments	25	—	—	25
Total assets carried at fair value	\$ 4,104,006	\$ —	\$ 3,998,761	\$ 105,245
Liabilities:				
Derivative liabilities	\$ 42,537	\$ —	\$ 42,537	\$ —
Total liabilities carried at fair value	\$ 42,537	\$ —	\$ 42,537	\$ —

The Company did not have assets or liabilities measured at fair value on a non-recurring basis as of December 31, 2013 or December 31, 2012.

The Company's valuation of its interest rate swaps is determined using the income approach. Derivative assets and liabilities include interest rate swaps and Eurodollar futures. The primary input into the valuation of interest rate swaps is the forward interest rate swap curve, which is considered an observable input and thus their fair values are considered Level 2 measurements. The Company's valuation of its Eurodollar futures is based on the closing exchange prices. Accordingly, these financial futures are classified as Level 1.

The Company's Agency MBS, as well a majority of its non-Agency MBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple dealer quotes and thus are considered Level 2 fair value measurements. The Company's remaining non-Agency MBS are comprised of securities for which there are not substantially similar securities that trade frequently, and their fair values are therefore considered Level 3 measurements. The Company determines the fair value of its Level 3 securities by discounting the estimated future cash flows derived from cash flow models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant inputs into those pricing models are Level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security's credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Significant changes in any of these inputs in isolation would result in a significantly different fair value measurement. Generally Level 3 assets are most sensitive to the default rate and severity assumptions.

The table below presents information about the significant unobservable inputs used in the fair value measurement for the Company's Level 3 non-Agency CMBS and RMBS as of December 31, 2013:

Quantitative Information about Level 3 Fair Value Measurements <sup>(1)</sup>				
	Prepayment Speed	Default Rate	Severity	Discount Rate
Non-Agency CMBS	20 CPY	2.5%	35.0%	8.7%
Non-Agency RMBS	10 CPR	1.0%	19.2%	8.1%

(1) Data presented are weighted averages.

The following table presents the activity of the instruments fair valued at Level 3 during the year ended December 31, 2013:

	Year Ended December 31, 2013			
	Level 3 Fair Values			
	Non-Agency CMBS	Non-Agency RMBS	Other	Total assets
Balance as of January 1, 2011	\$ 123,703	\$ 10,296	\$ 25	\$ 134,024
Purchases	—	7,500	—	7,500
Transfers out to Level 2	(4,670)	—	—	(4,670)
Change in fair value included in OCI	(59)	86	—	27
Principal payments	(18,437)	(12,804)	—	(31,241)
(Amortization) accretion	(435)	40	—	(395)
Balance as of December 31, 2012	\$ 100,102	\$ 5,118	\$ 25	\$ 105,245
Purchases	26,021	—	—	26,021
Sales/write-offs to net income	—	—	(25)	(25)
Change in fair value included in OCI	(6,026)	5	—	(6,021)
Principal payments	(49,167)	(2,421)	—	(51,588)
(Amortization) accretion	(197)	45	—	(152)
Balance as of December 31, 2013	\$ 70,733	\$ 2,747	\$ —	\$ 73,480

The following table presents a summary of the recorded basis and estimated fair values of the Company's financial instruments as of the dates indicated:

	December 31, 2013		December 31, 2012	
	Recorded Basis	Fair Value	Recorded Basis	Fair Value
<b>Assets:</b>				
Mortgage-backed securities	\$ 4,018,161	\$ 4,018,161	\$ 4,103,981	\$ 4,103,981
Securitized mortgage loans, net <sup>(1)</sup>	54,748	45,750	70,823	61,916
Other investments <sup>(1)</sup>	675	633	858	810
Derivative assets	18,488	18,488	—	—
<b>Liabilities:</b>				
Repurchase agreements <sup>(2)</sup>	\$ 3,580,754	\$ 3,580,997	\$ 3,564,128	\$ 3,564,787
Non-recourse collateralized financing <sup>(1)</sup>	12,914	12,414	30,504	30,756
Derivative liabilities	6,681	6,681	42,537	42,537

<sup>(1)</sup> The Company determines the fair value of its securitized mortgage loans and other investments and its non-recourse collateralized financing using internally developed cash flow models with inputs similar to those used to estimate fair value of the Company's Level 3 non-Agency MBS.

<sup>(2)</sup> The difference between the recorded basis of repurchase agreements and their fair value is the deferred cost of the 2-year repurchase facility.

## NOTE 10 – SHAREHOLDERS' EQUITY

### Preferred Stock

The Company has 2,300,000 shares of its 8.50% Series A Cumulative Redeemable Preferred Stock and 2,250,000 shares of its 7.625% Series B Cumulative Redeemable Preferred Stock issued and outstanding as of December 31, 2013 (collectively, the "Preferred Stock"). The Preferred Stock has no maturity and will remain outstanding indefinitely unless redeemed or otherwise

repurchased or converted into common stock pursuant to the terms of the Preferred Stock. Except under certain limited circumstances intended to preserve the Company's REIT status, upon the occurrence of a change in control as defined in Article IIIA, Section 7(d) of the Company's Articles of Incorporation, or to avoid the direct or indirect imposition of a penalty tax in respect of, or to protect the tax status of, any of the Company's real estate mortgage investment conduits ("REMIC") interests or a REMIC in which the Company may acquire an interest (as permitted by the Company's Articles of Incorporation), the Company may not redeem the Series A Preferred Stock prior to July 31, 2017 or the Series B Preferred Stock prior to April 30, 2018. On or after these dates, at any time and from time to time, the Preferred Stock may be redeemed in whole, or in part, at the Company's option at a cash redemption price of \$25.00 per share plus any accumulated and unpaid dividends. The Series A Preferred Stock pays a cumulative cash dividend equivalent to 8.50% of the \$25.00 liquidation preference per share each year and the Series B Preferred Stock pays a cumulative cash dividend equivalent to 7.625% of the \$25.00 liquidation preference per share each year. Because the Preferred Stock is redeemable only at the option of the issuer, it is classified as equity on the Company's consolidated balance sheet.

## Common Stock

The following table presents a summary of the changes in the number of common shares outstanding for the periods presented:

	2013	2012
Balance as of January 1,	54,268,915	40,382,530
Common stock issued under DRIP	515,257	13,480
Common stock issued under ATM program	180,986	402,494
Common stock issued or redeemed under stock and incentive plans	270,158	241,663
Common stock issued via public offering	—	13,332,748
Common stock forfeited for tax withholding on share-based compensation	(52,385)	—
Common stock repurchased during the period (weighted average price of \$8.09 and \$8.86 per share, respectively)	(872,447)	(104,000)
Balance as of December 31,	54,310,484	54,268,915

The Company has approximately 7,416,520 shares of common stock that remain available to offer and sell through its sales agent, JMP Securities LLC, under its "at the market", or "ATM" program, as of December 31, 2013.

The Company's Dividend Reinvestment and Share Purchase Plan ("DRIP") allows registered shareholders to automatically reinvest some or all of their quarterly common stock dividends in shares of the Company's common stock and provides an opportunity for investors to purchase shares of the Company's common stock, potentially at a discount to the prevailing market price. Of the 3,000,000 shares reserved for issuance under the Company's DRIP, there are 2,466,898 shares remaining for issuance as of December 31, 2013. The Company has declared a fourth quarter common stock dividend of \$0.27 per share payable on January 31, 2014 to shareholders of record as of December 31, 2013. There was no discount for shares purchased through the DRIP during the fourth quarter of 2013.

The following table summarizes dividends declared per share of common stock for years ending December 31, 2013, 2012, and 2011 and their related tax characterization:

	Dividends Declared per Common Share	Tax Characterization		
		Ordinary	Capital Gain	Return of Capital
Year ended December 31, 2013	\$ 1.1200	\$ 1.0650	\$ 0.0550	\$ —
Year ended December 31, 2012	1.1500	1.0038	0.1462	—
Year ended December 31, 2011	1.0900	0.9822	0.1078	—

Of the \$50,000 authorized by the Company's Board of Directors for the repurchase of its common stock through December 31, 2014, approximately \$42,145 remains available for repurchase at the Company's option as of December 31, 2013.

*Incentive Plans.* Pursuant to the Company's 2009 Stock and Incentive Plan, the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, SARs, dividend equivalent rights, performance shares, incentive awards, and restricted stock units. Of the 2,500,000 shares of common stock authorized for issuance under this plan, 1,550,118 shares remain available for issuance as of December 31, 2013. Total stock-based compensation expense recognized by the Company for the year ended December 31, 2013 was \$2,354 compared to \$1,828 and \$917 for the years ended December 31, 2012 and December 31, 2011, respectively.

The following table presents a rollforward of the restricted stock activity for the periods indicated:

	Year Ended December 31,	
	2013	2012
Restricted stock outstanding as of beginning of period	448,283	365,506
Restricted stock granted	255,158	220,821
Restricted stock vested	(182,472)	(138,044)
Restricted stock outstanding as of end of period	520,969	448,283

The restricted stock granted during the year ended December 31, 2013 and December 31, 2012 had fair values of \$2,708 and \$2,073, respectively, at their grant dates. As of December 31, 2013, the balance of the Company's outstanding restricted stock remaining to be amortized into compensation expense is \$3,311 of which \$1,643 is expected to be amortized in 2014, \$1,155 in 2015, \$447 in 2016, and \$66 in 2017.

During the year ended December 31, 2013, the Company's remaining 27,500 SARs were exercised pursuant to the Company's 2004 Stock Incentive Plan at their exercise price of \$7.06 per share. There are no other awards outstanding under the 2004 Stock Incentive Plan, and no new awards may be granted under this plan.

#### NOTE 11 – INCOME TAXES

The Company's estimated REIT taxable income before consideration of its net operating loss carryforward was \$71,765 for the year ended December 31, 2013, \$73,962 for the year ended December 31, 2012, and \$43,988 for the year ended December 31, 2011. After common and preferred dividend distributions during those years as well as utilization of the Company's tax net operating loss ("NOL") carryforward to offset taxable earnings, the Company does not expect to incur any income tax liability for the year ended December 31, 2013 and did not incur any income tax liability for the years ending December 31, 2012 or December 31, 2011.

The Company estimated NOL carryforward as of December 31, 2013 is \$142,252. As a result of its common stock offering in February 2012, the Company incurred an "ownership change" under Section 382 of the Internal Revenue Code ("Section 382"). In general, if a company incurs an ownership change under Section 382, the company's ability to utilize an NOL carryforward to offset its taxable income after any required dividend distributions becomes limited to a certain amount per year. Due to the ownership change, the Company's ability to use its NOL is limited to an estimated \$13,451 per year. The NOL will begin to expire principally in the years 2020-2024 to the extent it is not used. While the Company has not finalized its 2013 income tax return, it expects to utilize less than \$2,000 of the NOL in 2013.

The Company also has a taxable REIT subsidiary ("TRS"), which has an estimated NOL carryforward of \$3,504 as of December 31, 2013 compared to \$4,204 as of December 31, 2012. The Company's TRS recognized income of \$721 during the year ended December 31, 2013 from its investment in a limited partnership, which was dissolved prior to December 31, 2013. The



Company's TRS has limited operations, and accordingly, the Company has established a full valuation allowance for the related deferred tax asset.

After reviewing for any potentially uncertain income tax positions, the Company has concluded that it does not have any uncertain tax positions that meet the recognition or measurement criteria of ASC 740 as of December 31, 2013, December 31, 2012, or December 31, 2011, although its tax returns for those tax years are open to examination by the IRS. In the event that the Company incurs income tax related interest and penalties, its policy is to classify them as a component of provision for income taxes.

## **NOTE 12 – COMMITMENTS AND CONTINGENCIES**

The Company records accruals for certain outstanding legal proceedings, investigations or claims when it is probable that a liability will be incurred and the amount of the loss can be reasonably estimated. The Company evaluates, on a quarterly basis, developments in legal proceedings, investigations and claims that could affect the amount of any accrual, as well as any developments that would make a loss contingency both probable and reasonably estimable. When a loss contingency is not both probable and reasonably estimable, the Company does not accrue the loss. However, if the loss (or an additional loss in excess of the accrual) is at least a reasonable possibility and material, then the Company discloses a reasonable estimate of the possible loss or range of loss, if such reasonable estimate can be made. If the Company cannot make a reasonable estimate of the possible material loss, or range of loss, then that fact is disclosed.

The Company and its subsidiaries are parties to various legal proceedings, including those described below. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings, including those described below, will not have a material effect on the Company's consolidated financial condition or liquidity. However, the resolution of any of the proceedings described below could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

One of the Company's subsidiaries, GLS Capital, Inc. ("GLS"), the County of Allegheny, Pennsylvania ("Allegheny County"), and the Company are named defendants in a putative class action lawsuit filed in June 2012 in the Court of Common Pleas of Allegheny County, Pennsylvania ("the Court"). Between 1995 and 1997, GLS purchased from Allegheny County delinquent property tax lien receivables for properties located in the county. The purported class in this action consists of owners of real estate in Allegheny County whose property is or has been subject to a tax lien filed by Allegheny County that Allegheny County either retained or sold to GLS and who were billed by Allegheny County or GLS for attorneys' fees, interest, and certain other fees and who sustained economic damages on and after August 14, 2003. The putative class allegations are that Allegheny County, GLS, and the Company violated the class's constitutional due process rights in connection with delinquent tax collection efforts. There are also allegations that amounts recovered from the class by GLS and / or Allegheny County are an unconstitutional taking of private property. The claims against the Company are solely based upon its ownership of GLS. The complaint requests that the Court order GLS to account for amounts alleged to have been collected in violation of the putative class members' rights and create a constructive trust for the return of such amounts to members of the purported class. The Company believes the claims are without merit and intends to defend against them vigorously in this matter. The same class previously filed substantially the same lawsuit in 2004 against GLS and Allegheny County (ACORN v. County of Allegheny and GLS Capital, Inc.), and that case was dismissed by the Court of Common Pleas with prejudice on June 28, 2013.

The Company and DCI Commercial, Inc. ("DCI"), a former affiliate of the Company and formerly known as Dynex Commercial, Inc., are appellees (or respondents) in the matter of Basic Capital Management, Inc. et al. (collectively, "BCM" or the "Plaintiffs") versus DCI et al. currently pending in state court in Dallas, Texas. The matter was initially filed in the state court in Dallas County, Texas in April 1999 against DCI, and in March 2000, BCM amended the complaint and added the Company as a defendant. Following a trial court decision in favor of both the Company and DCI, Plaintiffs appealed, seeking reversal of the trial court's judgment and rendition of judgment against the Company for alleged breach of loan agreements for tenant improvements in the amount of \$250. Plaintiffs also sought reversal of the trial court's judgment and rendition of judgment against DCI in favor of BCM under two mutually exclusive damage models, for \$2,200 and \$25,600, respectively, related to the alleged breach by DCI of a \$160,000 "master" loan commitment. Plaintiffs also sought reversal and rendition of a judgment in their favor for attorneys' fees in the amount of \$2,100. Alternatively, Plaintiffs sought a new trial. On February 13, 2013, the Fifth Circuit Court of Appeals in Dallas, Texas (the "Fifth Circuit") ruled on Plaintiffs' appeal, affirming the previous decision of no liability with respect to the

Company, and reversing the previous decision of no liability with respect to DCI relating to the \$160,000 “master” loan commitment. The Fifth Circuit ordered a new trial to determine the amount of attorneys' fees and prejudgment and post-judgment interest due to Plaintiffs and reinstated the \$25,600 damage award against DCI. On May 22, 2013, the Fifth Circuit vacated its order on February 13, 2013 and remanded the case to the trial court for entry of judgment against DCI and for a new trial with respect to attorneys' fees and for costs and pre-judgment and post-judgment interest as determined by the trial court. The Fifth Circuit also affirmed the trial court's decision with respect to a take nothing judgment against the Company. DCI has appealed the matter to the Supreme Court of Texas to reverse the \$25,600 damage award. Management believes the Company will not be obligated for any amounts that may ultimately be awarded against DCI.

#### NOTE 13 – RELATED PARTY TRANSACTIONS

As discussed in Note 12, the Company and DCI were jointly named in litigation regarding the activities of DCI while it was an operating subsidiary of an affiliate of the Company. In December 2000, the Company and DCI entered into a Litigation Cost Sharing Agreement whereby the parties set forth how the costs of defending against such litigation would be shared, and whereby the Company agreed to advance DCI's portion of the costs of defending against such litigation. The Litigation Cost Sharing Agreement remains in effect as of December 31, 2013. DCI costs advanced by the Company are loans and bear simple interest at the rate of Prime plus 8.0% per annum. As of December 31, 2013, the total amount due to the Company under the Litigation Cost Sharing Agreement, including interest, was \$8,397, which has been fully reserved for collectibility by the Company. DCI is currently wholly owned by a company unaffiliated with the Company. An executive of the Company is the sole shareholder of this unaffiliated company.

#### NOTE 14 - SELECTED QUARTERLY INFORMATION (UNAUDITED)

	Year Ended December 31, 2013			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Operating results:				
Net interest income	\$ 22,526	\$ 22,444	\$ 22,948	\$ 20,186
Net interest income after provision for loan losses	22,265	22,444	22,948	20,186
Net income to common shareholders	18,381	29,442	(6,921)	19,266
Comprehensive income (loss) to common shareholders	27,427	(67,215)	(6,184)	19,813
Basic net income per common share	\$ 0.34	\$ 0.54	\$ (0.13)	\$ 0.35
Diluted net income per common share	\$ 0.34	\$ 0.54	\$ (0.13)	\$ 0.35
Cash dividends declared per common share	\$ 0.29	\$ 0.29	\$ 0.27	\$ 0.27

	Year Ended December 31, 2012			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Operating results:				
Net interest income	\$ 19,147	\$ 19,008	\$ 19,100	\$ 21,145
Net interest income after provision for loan losses	19,087	19,008	18,990	21,123
Net income to common shareholders	16,476	18,847	18,353	18,330
Comprehensive income to common shareholders	42,655	17,429	52,737	14,951
Basic net income per common share	\$ 0.33	\$ 0.35	\$ 0.34	\$ 0.34
Diluted net income per common share	\$ 0.33	\$ 0.35	\$ 0.34	\$ 0.34
Cash dividends declared per common share	\$ 0.28	\$ 0.29	\$ 0.29	\$ 0.29

	Year Ended December 31, 2011			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Operating results:				
Net interest income	\$ 12,731	\$ 15,033	\$ 14,559	\$ 16,972
Net interest income after provision for loan losses	12,481	14,833	14,259	16,851
Net income to common shareholders	10,280	13,594	1,532	14,406
Comprehensive income (loss) to common shareholders	6,606	13,910	(6,772)	12,756
Basic net income per common share	\$ 0.31	\$ 0.34	\$ 0.04	\$ 0.36
Diluted net income per common share	\$ 0.31	\$ 0.34	\$ 0.04	\$ 0.36
Cash dividends declared per common share	\$ 0.27	\$ 0.27	\$ 0.27	\$ 0.28

#### NOTE 15 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Annual Report on Form 10-K was filed with the SEC and has determined that there have been no significant events or circumstances that qualify as a "recognized" subsequent event as defined by ASC Topic 855. Management has determined that the following events or circumstances qualify as "nonrecognized" subsequent events as defined by ASC Topic 855:

Subsequent to December 31, 2013, the Company granted 428,363 shares of restricted stock with a combined fair value at grant date of \$3,453. The fair value of these restricted shares will be amortized into share-based compensation expense in accordance with their respective vesting periods. Approximately 50% of these shares will vest annually over the next 3 years with the remaining 50% vesting annually over the next 4 years.

**AMENDED AND RESTATED BYLAWS**

**OF**

**DYNEX CAPITAL, INC.,  
a Virginia corporation**

**Amended as of  
December 12, 2013**

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## ARTICLE I

### Offices and Fiscal Year

SECTION 1.01        Principal Office. The principal office of the Corporation shall be located at 4551 Cox Road, Suite 300, Glen Allen, Virginia 23060, until otherwise established by a vote of a majority of the Board of Directors.

SECTION 1.02        Other Offices. The Corporation also may have offices at such places within or without the Commonwealth of Virginia as the Board of Directors may from time to time designate or the business of the Corporation may require.

SECTION 1.03        Fiscal Year. The fiscal year of the Corporation shall begin on the first day of January and end on the 31st day of December.

## ARTICLE II

### Meetings of Shareholders

SECTION 2.01        Places of Meeting. All meetings of the shareholders of the Corporation shall be held at such place, either within or without the Commonwealth of Virginia, as from time to time may be fixed by the President or by the Board of Directors in the notice of such meeting.

SECTION 2.02        Annual Meetings. The President or the Board of Directors may fix the date and time of the annual meeting of the shareholders, but if no such date and time is fixed by the President or the Board of Directors, the meeting for any calendar year shall be held on the fourth Monday in March in such year, if not a legal holiday under the laws of Virginia, and, if a legal holiday, then on the next succeeding business day, at 10:00 a.m., and at such meeting the shareholders then entitled to vote shall elect directors and shall transact such other business as may properly be brought before the meeting. Failure to hold an annual meeting does not invalidate the Corporation's existence or affect any otherwise valid corporate acts.

SECTION 2.03        Special Meetings. Special meetings of the shareholders of the Corporation for any purpose or purposes may be called at any time by the President, the Chairman of the Board of Directors, by a majority of the Board of Directors, by a majority of the Unaffiliated Directors (as defined in Section 3.02 hereof), or by



shareholders entitled to cast at least twenty-five percent (25%) of the votes which all shareholders are entitled to cast at the particular meeting.

At any time, upon the written consent of any person or persons who have duly called a special meeting, which written request shall state the object of the meeting, it shall be the duty of the Secretary to fix the date of the meeting to be held at such date and time as the Secretary may fix, not less than ten nor more than sixty days after the receipt of the request, and to give due notice thereof. If the Secretary shall neglect or refuse to fix the date and time of such meeting and give notice thereof, the person or persons calling the meeting may do so.

SECTION 2.04 Notice of Meetings. Written notice of every meeting of the shareholders, whether annual or special, shall be given to each shareholder of record entitled to vote at the meeting, at least ten and not more than sixty days prior to the day named for the meeting, except that notice of a meeting of shareholders to act on an amendment to the Articles of Incorporation, a plan of merger or share exchange, a proposed sale of assets pursuant to Va. Code § 13.1-724, or the dissolution of the Corporation shall be given not less than twenty-five nor more than sixty days prior to the day named for the meeting. Every notice of a special meeting shall state briefly the purpose or purposes thereof, and no business, other than that specified in such notice and matters germane thereto, shall be transacted at any special meeting without further notice to shareholders not present in person or by proxy.

Whenever the language of a proposed resolution is included in a written notice of a meeting of shareholders, the resolution may be adopted at such meeting with such clarifying or other amendments as do not enlarge its original purpose without further notice to shareholders not present in person or by proxy.

SECTION 2.05 Quorum, Manner of Acting and Adjournment. The presence in person or by proxy of shareholders entitled to cast a majority of the votes which all shareholders are entitled to cast on the particular matter shall constitute a quorum for the purpose of considering such matter. The shareholders present in person or by proxy at a duly organized meeting can continue to do business until adjournment, notwithstanding the withdrawal of enough shareholders from the meeting so that less than a quorum remains.

In the absence of a quorum or for any other reason, the Chairman of the meeting or the board of directors or the shareholders present in person or by proxy acting by a majority vote and without notice other than by announcement

at the meeting may adjourn the meeting from time to time but not for a period exceeding 120 days after the original meeting date.

Except as otherwise specified in the Articles of Incorporation or these Bylaws or provided by applicable law, at a duly organized meeting at which a quorum is present in person or by proxy, action on any matter (other than the election of directors) is approved by the shareholders if the votes cast favoring the matter exceed the votes cast opposing the matter.

SECTION 2.06        Organization. At every meeting of the shareholders, the Chairman of the Board, if there be one, shall conduct the meeting or, in the case of vacancy in office or absence of the Chairman of the Board, one of the following officers present shall conduct the meeting in the order stated: the Vice Chairman of the Board, if there be one, the President, the Vice Presidents in their order of rank and seniority, or a Chairman chosen by the shareholders entitled to cast a majority of the votes which all shareholders present in person or by proxy are entitled to cast, shall act as Chairman, and the Secretary, or, in his absence, an assistant secretary, or in the absence of both the Secretary and assistant secretaries, a person appointed by the Chairman shall act as Secretary.

At any meeting of shareholders of the Corporation, the chairman of the meeting shall have the right and authority to prescribe such rules, regulations and procedures and to do all such acts and things as are necessary or desirable for the proper conduct of the meeting, including, without limitation, the establishment of procedures for the dismissal of business not properly presented, the maintenance of order and safety, limitations on the time allotted to questions or comments on the affairs of the Corporation, restrictions on entry to such meeting after the time prescribed for the commencement thereof and the opening and closing of the voting polls. This Section 2.06 shall not limit the right of shareholders to speak at meetings of shareholders on matters germane to the Corporation's business, subject to any rules for the orderly conduct of the meeting imposed by the chairman of the meeting.

SECTION 2.07        Voting. Every shareholder entitled to vote at a meeting of shareholders or to express consent or dissent to corporate action in writing without a meeting may authorize another person or persons to act for him by proxy. Every proxy shall be executed in writing by the shareholder or by his duly authorized attorney-in-fact and filed with the Secretary of the Corporation. A proxy, unless coupled with an interest, shall be revocable at will, notwithstanding any other agreement or any provision in the proxy to the contrary, but the revocation of a proxy shall

not be effective until notice thereof has been given to the Secretary. No unrevoked proxy shall be valid after eleven months from the date of its execution, unless a longer time is expressly provided therein. A proxy shall not be revoked by the death or incapacity of the maker unless, before the authority is exercised, written notice of such death or incapacity is given to the secretary. A shareholder shall not sell his vote or execute a proxy to any person for any sum of money or anything of value.

Except as provided in Article III of the Articles of Incorporation, each shareholder of record, except the holder of shares which have been called for redemption and with respect to which an irrevocable deposit of funds has been made, shall have the right, at every shareholder meeting, to one vote for every share, and to a fraction of a vote equal to every fractional share.

SECTION 2.08        Voting Lists. The officer or agent of the Corporation having charge of the stock transfer books for shares of the Corporation shall make, at least ten days before each meeting of shareholders, a complete list of the shareholders entitled to vote at the meeting or any adjournment thereof, arranged in alphabetical order, with the address of and the number of shares held by each, which list shall be kept on file at the registered office of the Corporation or at the principal office or at the office of the transfer agent or registrar of the Corporation, and shall be subject to inspection by any shareholder at any time during usual business hours. Such list also shall be produced and kept open at the time and place of the meeting and shall be subject to the inspection of any shareholder during the whole time of the meeting. The original share ledger or stock transfer book, or a duplicate thereof shall be prima facie evidence as to who are the shareholders entitled to examine such list or share ledger or stock transfer book, or to vote, in person or by proxy, at any meeting of shareholders.

SECTION 2.09        Judges of Election. The vote upon any matter, including the election of directors, need not be by ballot. In advance of any meeting of shareholders the Board of Directors may appoint judges of election, who need not be shareholders, to act at such meeting or any adjournment thereof. If judges of election are not so appointed, the chairman of any such meeting may, and upon the demand of any shareholder or his proxy at the meeting and before voting begins shall, appoint judges of election. The number of judges shall be either one or three, as determined, in the case of judges appointed upon demand of a shareholder, by shareholders present entitled to cast a majority of the votes which all shareholders present are entitled to cast thereon. No person who is a candidate for office shall act as a judge.

In case any person appointed as judge fails to appear or fails or refuses to act, the vacancy may be filled by appointment made by the Board of Directors in advance of the convening of the meeting, or at a meeting by the chairman of the meeting.

If judges of election are appointed as aforesaid, they shall determine the number of shares outstanding and the voting power of each, the shares represented at the meeting, the existence of a quorum, the authenticity, validity and effect of proxies, receive votes or ballots, hear and determine all challenges and questions in any way arising in connection with the right to vote, count and tabulate all votes, determine the result, and do such acts as may be proper to conduct the election or vote with fairness to all shareholders. If there be three judges of election, the decision, act or certificate of a majority shall be effective in all respects as the decision, act or certificate of all.

On request of the chairman of the meeting or of any shareholder or his proxy, the judges shall make a report in writing of any challenge or question or matter determined by them and execute a certificate of any fact found by them.

SECTION 2.10      Determination of Shareholders of Record. The Board of Directors may fix a date, not more than seventy nor less than ten days preceding the date of any meeting of shareholders, and not more than seventy days preceding the date fixed for the payment of any dividend or distribution, or the date for the allotment of rights, or the date when any change or conversion or exchange of shares will be made or go into effect, as a record date for the determination of the shareholders entitled to notice of, or to vote at, any such meeting, or entitled to receive any such allotment of rights, or to exercise the rights in respect to any such change, conversion or exchange of shares; and in such case, if otherwise entitled to notice of, or to vote at, such meeting, or to receive payment of such dividend or distribution or to receive such allotment of rights, or exercise such rights, as the case may be, notwithstanding any transfer of any shares on the books of the Corporation after any such record date fixed as aforesaid.

Unless a record date is fixed by the Board of Directors for such purpose, transferees of shares which are transferred on the books within ten days next preceding the date of such meeting shall not be entitled to notice of, or to vote at, such meeting.

SECTION 2.11      Consent of Shareholders in Lieu of Meeting. Any action which may be taken at a meeting of the shareholders or a class of shareholders of the Corporation may be taken without a meeting if a consent

or consents in writing, setting forth the actions so taken, shall be signed by all the shareholders who would be entitled to vote at a meeting of the shareholders or of a class of shareholders for such purpose and shall be filed with the Secretary.

SECTION 2.12      Order of Business. At any meeting of shareholders of the Corporation, only that business that is properly brought before the meeting may be presented to and acted upon by shareholders. To be properly brought before an annual meeting, business must be brought (a) by or at the direction of the Board of Directors or (b) by any shareholder of the Corporation who shall be entitled to vote at such meeting and who complies with the notice procedures set forth in this Section 2.12. At a special meeting of shareholders, no business shall be transacted and no corporate action taken other than that stated in the notice of the meeting.

In addition to any other applicable requirements, for business to be properly brought before an annual meeting by a shareholder, the shareholder must have given timely notice thereof in writing to the secretary of the Corporation. To be timely, a shareholder's notice must be given, either by personal delivery or by United States certified mail, postage prepaid, and received at the principal executive offices of the Corporation (i) not less than 90 days nor more than 180 days before the first anniversary of the date of the Corporation's proxy statement in connection with the last annual meeting of shareholders or (b) if no annual meeting was held in the previous year or the date of the applicable annual meeting has been changed by more than 30 days from the date contemplated at the time of the previous year's proxy statement, not less than 90 days before the date of the applicable annual meeting. A shareholder's notice to the secretary shall set forth as to each matter the shareholder proposes to bring before the annual meeting (a) a brief description of the business desired to be brought before the annual meeting, including the complete text of any resolutions to be presented at the annual meeting, and the reasons for conducting such business at the annual meeting, (b) the name and address, as they appear on the Corporation's stock transfer books, of such shareholder proposing such business, (c) a representation that such shareholder is a shareholder of record and intends to appear in person or by proxy at such meeting to bring the business before the meeting specified in the notice, (d) the class and number of shares of stock of the Corporation beneficially owned by the shareholder and (e) any material interest of the shareholder in such business. The Secretary of the Corporation shall deliver each such shareholder's notice that has been timely received to the Board of Directors or a committee designated by the Board of Directors for review.

Notwithstanding anything in the Bylaws to the contrary, no business shall be conducted at an annual meeting except in accordance with the procedures set forth in this Section 2.12. The chairman of a meeting shall, if the facts

warrant, determine that the business was not brought before the meeting in accordance with the procedures prescribed by this Section 2.12, and if he should so determine, he shall so declare to the meeting and the business not properly brought before the meeting shall not be transacted.

In addition to the foregoing provisions of this Section 2.12, a shareholder seeking to have a proposal included in the Corporation's proxy statement shall comply with the requirements of Regulation 14A under the Securities Exchange Act of 1934, as amended (including, but not limited to, Rule 14a-8 or its successor provision). The Corporation shall not have any obligation to communicate with shareholders regarding any business or director nomination submitted by a shareholder in accordance with this Section 2.12 unless otherwise required by law.

### **ARTICLE III**

#### **Board of Directors**

SECTION 3.01        Powers. The Board of Directors shall have full power to conduct, manage, and direct the business and affairs of the Corporation, and all powers of the Corporation, except those specifically reserved or granted to the shareholders by statute or by the Articles of Incorporation or these Bylaws, are hereby granted to and vested in the Board of Directors.

SECTION 3.02        Number, Election and Term. The Board of Directors shall consist of seven directors, subject to automatic increase in accordance with the Articles of Incorporation. If the Corporation seeks to qualify as a real estate investment trust, the number of directors shall be increased or decreased from time to time by vote of a majority of the entire Board of Directors; provided, however, that the number of directors may not exceed fifteen nor be less than three except as permitted by law, and provided further, that the tenure of office of a director shall not be affected by any decrease or increase in the number of directors so made by the Board of Directors. During such time as the Corporation seeks to qualify as a real estate investment trust, except in the case of a vacancy, a majority of the Board of Directors shall be Unaffiliated Directors (as hereinafter defined). For purposes of these Bylaws, "Unaffiliated Director" shall mean a director of the Corporation who is not affiliated, directly or indirectly with any person or entity, if any, responsible for directing and performing the day-to-day business affairs of the Corporation (the "Manager"), whether by ownership of, ownership interest in, employment by, any material business or professional relationship with, or serves as an officer or director of the Manager or an affiliated business entity of the Manager; provided, however,

that a Director shall not be considered Unaffiliated if he or she is serving as a director of more than three REITs organized by the Manager or its affiliated business entities. “Affiliate” means, when used with reference to a specified person, (i) any person that directly or indirectly controls or is controlled by or is under common control with the specified person, (ii) any person that is an officer of, partner in or trustee of, or serves in a similar capacity with respect to, the specified person or of which the specified person is an officer, partner or trustee, or with respect to which the specified person serves in a similar capacity, and (iii) any person that, directly or indirectly, is the beneficial owner of 5% or more of any class of equity securities of the specified person or of which the specified person is directly or indirectly the owner of 5% or more of any class of equity securities (“person” includes a natural person, corporation, partnership, trust company or other entity). At the first annual meeting of shareholders and at each annual meeting thereafter, the shareholders shall elect directors to hold office until the next annual meeting or until their successors are elected and qualify. Directors need not be shareholders in the Corporation.

Except as provided in Article III of the Articles of Incorporation, no person shall be eligible for election as a director unless nominated in accordance with the procedures set forth in this Section 3.02. Nominations of persons for election to the Board of Directors may be made by the Board of Directors or any committee designated by the Board of Directors or by any shareholder entitled to vote for the election of directors at the applicable meeting of shareholders who complies with the notice procedures set forth in this Section 3.02. Such nominations, other than those made by the Board of Directors or any committee designated by the Board of Directors, may be made only if written notice of a shareholder’s intent to nominate one or more persons for election as directors at the applicable meeting of shareholders has been given, either by personal delivery or by United States certified mail, postage prepaid, to the secretary of the Corporation and received (a) not less than 90 days nor more than 180 days before the first anniversary of the date of the Corporation’s proxy statement in connection with the last annual meeting of shareholders, or (b) if no annual meeting was held in the previous year or the date of the applicable annual meeting has been changed by more than 30 days from the date contemplated at the time of the previous year’s proxy statement, not less than 90 days before the date of the applicable annual meeting. Each such shareholder’s notice shall set forth (i) as to the shareholder giving the notice, (1) the name and address, as they appear on the Corporation’s stock transfer books, of such shareholder, (2) a representation that such shareholder is a shareholder of record and intends to appear in person or by proxy at such meeting to nominate the person or persons specified in the notice, (3) the class and number of shares of stock of the Corporation beneficially

owned by such shareholder, and (4) a description of all arrangements or understandings between such shareholder and each nominee and any other person or persons (naming such person or persons) pursuant to which the nomination or nominations are to be made by such shareholder; and (ii) as to each person whom the shareholder proposes to nominate for election as a director, (1) the name, age, business address and, if known, residence address of such person, (2) the principal occupation or employment of such person, (3) the class and number of shares of stock of the Corporation which are beneficially owned by such person, (4) any other information relating to such person that is required to be disclosed in solicitations of proxies for election of directors or is otherwise required by the rules and regulations of the Securities and Exchange Commission promulgated under the Securities Exchange Act of 1934, as amended, and (5) the written consent of such person to be named in the proxy statement as a nominee and to serve as a director if elected. The secretary of the Corporation shall deliver each such shareholder's notice that has been timely received to the Board of Directors or a committee designated by the Board of Directors for review. Any person nominated for election as director by the Board of Directors or any committee designated by the Board of Directors shall, upon the request of the Board of Directors or such committee, furnish to the secretary of the Corporation all such information pertaining to such person that is required to be set forth in a shareholder's notice of nomination. The chairman of the meeting of shareholders shall, if the facts warrant, determine that a nomination was not made in accordance with the procedures prescribed by this Section 3.02, and if he should so determine, he shall so declare to the meeting and the defective nomination shall be disregarded.

At any time when the Chairman of the Board is also serving as an officer of the Corporation other than Chairman of the Board, the Board of Directors shall designate one of its other directors who is not serving as an officer of the Corporation as the lead independent director of the Corporation.

SECTION 3.03        Vacancies. Except as provided in Article III of the Articles of Incorporation, any vacancy occurring on the Board of Directors for any cause other than by reason of an increase in the number of directors may, subject to the provisions of Section 3.05, be filled by a majority of the remaining members of the Board of Directors, although such majority is less than a quorum; provided, however, that if the Corporation has sought to qualify as a real estate investment trust and in accordance with Section 3.02 a majority of the Board of Directors are required to be Unaffiliated Directors, then Unaffiliated Directors shall nominate replacements for vacancies among the Unaffiliated



Directors, which replacements must be elected by a majority of the directors, including a majority of the Unaffiliated Directors. Except as provided in Article III of the Articles of Incorporation, any vacancy occurring by reason of an increase in the number of directors may be filled by action of a majority of the entire Board of Directors including a majority of Unaffiliated Directors. If the shareholders of any class or series are entitled separately to elect one or more directors, a majority of the remaining directors elected by that class or series or the sole remaining director elected by that class or series may fill any vacancy among the number of directors elected by that class or series. A director elected by the Board of Directors to fill a vacancy shall be elected to hold office until the next annual meeting of shareholders or until his successor is elected and qualified.

SECTION 3.04        Resignations. Any director or member of a committee may resign at any time. Such resignation shall be made in writing and shall take effect at the time specified therein, or if no time be specified, at the time of the receipt by the Chairman of the Board, the President or the Secretary.

SECTION 3.05        Removal. At any meeting of shareholders, duly called and at which a quorum is present, the shareholders may, by the affirmative vote of the holders of a majority of the votes entitled to be cast thereon, remove any director or directors from office with or without cause, and may elect a successor or successors to fill any resulting vacancies for the unexpired terms of removed directors.

SECTION 3.06        Committees of the Board. The Board of Directors may appoint from among its members an executive committee and other committees comprised of three or more directors. A majority of the members of any committee so appointed shall be Unaffiliated Directors. If the Corporation lists its shares on a national securities exchange, the Board of Directors shall appoint an audit committee comprised of not less than three members, all of whom are Unaffiliated Directors. The Board of Directors may delegate to any committee any of the powers of the Board of Directors except the power to elect directors, declare dividends or distributions on stock, recommend to the shareholders any action which requires shareholder approval, amend the Articles of Incorporation, amend or repeal the Bylaws, approve any merger or share exchange which does not require shareholder approval or issue stock. However, if the Board of Directors has given general authorization for the issuance of stock, a committee of the Board, in accordance with a general formula or method specified by the Board of Directors by resolution or by adoption of a

stock option plan, may fix the terms of stock subject to classification or reclassification and the terms on which any stock may be issued.

Notice of committee meetings shall be given in the same manner as notice for special meetings of the Board of Directors.

One-third, but not less than two, of the members of any committee shall be present in person at any meeting of such committee in order to constitute a quorum for the transaction of business at such meeting, and the act of a majority present shall be the act of such committee.

The Board of Directors may designate a chairman of any committee, and such chairman or any two members of any committee may fix the time and place of its meetings unless the Board shall otherwise provide. In the absence or disqualification of any member of any such committee, the members thereof present at any meeting and not disqualified from voting, whether or not they constitute a quorum, may unanimously appoint another director to act at the meeting in the place of such absent or disqualified members; provided, however, that in the event of the absence or disqualification of an Unaffiliated Director, such appointee shall be an Unaffiliated Director.

Each committee shall keep minutes of its proceedings and shall report the same to the Board of Directors at the meeting next succeeding and any action by the committees shall be subject to revision and alteration by the Board of Directors, provided that no rights of third persons shall be affected by any such revision or alteration.

Subject to the provisions hereof, the Board of Directors shall have the power at any time to change the membership of any committee, to fill all vacancies, to designate alternative members to replace any absent or disqualified member, or to dissolve any such committee.

SECTION 3.07            Meetings of the Board of Directors. Meetings of the Board of Directors, regular or special, may be held at any place in or out of the Commonwealth of Virginia as the Board may from time to time determine or as shall be specified in the notice of such meeting.

The first meeting of each newly elected Board of Directors shall be held as soon as practicable after the annual meeting of the shareholders at which the directors were elected. The meeting may be held at such time and place as shall be specified in a notice given as hereinafter provided for special meetings of the Board of Directors, or as shall be specified in a written waiver signed by all of the directors as provided in Article IV, except that no notice shall be necessary if such meeting is held immediately after the adjournment, and at the site, of the annual meeting of shareholders.

Special meetings of the Board of Directors may be called at any time by two or more directors, by any lead independent director (if one has been designated) or by a majority of the members of the executive committee, if one be constituted, in writing with or without a meeting of such committee or by the Chairman of the Board or the President. The lead independent director (if one has been designated) may also call a separate meeting of the directors of the Corporation who are not employees of the Corporation. Special meetings may be held at such place or places in or out of the Commonwealth of Virginia as may be designated from time to time by the Board of Directors; in the absence of such designation, such meetings shall be held at such places as may be designated in the notice of meeting.

Notice of the place and time of every meeting of the Board of Directors shall be delivered by the Secretary to each director personally, by first-class mail, or by telephone, which shall also include voice-mail, or by electronic mail to any electronic address of the director or by any other electronic means, or by leaving the same at his residence or usual place of business at least twenty-four hours before the time at which such meeting is to be held, or if by first class mail, at least four days before the day on which such meeting is to be held. If mailed, such notice shall be deemed to be given when deposited in the United States mail addressed to the director at his post office address as it appears on the records of the Corporation, with postage thereon prepaid.

SECTION 3.08      Quorum and Voting. At all meetings of the Board, a majority of the entire Board of Directors shall constitute a quorum for the transaction of business, and the action of a majority of the directors present at any meeting at which a quorum is present shall be the action of the Board of Directors unless the concurrence of a greater proportion is required for such action by law, the Corporation's Articles of Incorporation or these Bylaws. If a quorum shall not be present at any meeting of directors, the directors present thereat may, by a majority vote, adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum shall be present.

Notwithstanding the first paragraph of this Section 3.08, and except as provided in the Company's Guidelines (as hereinafter defined) any action pertaining to a transaction involving the Corporation in which any advisor, any director or officer of the Corporation or any affiliate of any of the foregoing persons has an interest shall be approved by a majority of the Unaffiliated Directors even if the Unaffiliated Directors constitute less than a quorum. In approving any such transaction or series of transactions the Unaffiliated Directors must determine that:

- (a)      the transaction as contemplated is fair and reasonable to the Corporation and its shareholders:

(b) if an acquisition of property other than mortgage collateral is involved, the total consideration is not in excess of the appraised value of such property being acquired; and

(c) if the transaction involves compensation to the Manager or any of its affiliates for services rendered in a capacity other than that contemplated by the management arrangements, to the knowledge of the directors such compensation is not greater than the customary charges for comparable services generally available from other competent unaffiliated persons.

SECTION 3.09            Organization. The Chairman of the Board shall preside at each meeting of the Board of Directors; provided, however, that the lead independent director (if one has been designated) shall preside at any separate meeting of directors of the Corporation who are not employees of the Corporation. In the absence or inability of the Chairman of the Board to preside at a meeting of the Board of Directors, the President, or, in his absence or inability to act, the lead independent director (if one has been designated), or in their absence or inability to act, another director chosen by a majority of the directors present, shall act as chairman of the meeting and preside thereat. The Secretary (or, in his absence or inability to act, any person appointed by the chairman of the meeting) shall act as Secretary of the meeting and keep the minutes thereof.

SECTION 3.10            Meeting by Conference Telephone. Members of the Board of Directors may participate in a meeting by means of a conference telephone or similar communications equipment if all persons participating in the meeting can hear each other at the same time. Participation in a meeting by such means constitutes presence in person at a meeting.

SECTION 3.11            Action Without Meeting. Any action required or permitted to be taken at any meeting of the Board of Directors or of any committee thereof may be taken without a meeting, if a written consent to such action is signed by all members of the Board or of such committee, as the case may be, and such written consent is filed with the minutes of proceedings of the Board or committee.

SECTION 3.12            Compensation of Directors. Unaffiliated Directors shall receive a stated salary for their services or a fixed sum, and expenses of attendance for attendance at each regular or special meeting of the Board of Directors, or of any committee thereof or both, as may be determined from time to time by the Board. Nothing herein

contained shall be construed to preclude any director from serving the Corporation in any other capacity and receiving compensation therefor.

SECTION 3.13        Investment Policies. It shall be the duty of the Board of Directors to ensure that the purchase, sale, retention and disposal of the Corporation's assets, and the investment policies of the Corporation and the limitations thereon are at all times in compliance with the restrictions applicable to real estate investment trusts pursuant to the Internal Revenue Code of 1936, as amended.

The Board of Directors, including a majority of the Independent Directors, shall promulgate and approve guidelines governing the investment policies of the Company (the "Guidelines"). The Guidelines and compliance therewith shall be reviewed by the Board of Directors at least annually to determine that the policies then being followed by the Corporation are in the best interest of the shareholders of the Corporation. Each such determination and the basis therefor shall be set forth in the minutes of the meeting of the Board of Directors.

## ARTICLE IV

### Notice - Waivers - Meetings

SECTION 4.01        What Constitutes Notice. Whenever written notice is required to be given to any person under the provisions of the Articles, these Bylaws, or the Virginia Stock Corporation Act, it may be given to such person, either personally or by sending a copy thereof through the mail, or by telegraph, charges prepaid, to his address appearing on the books of the Corporation, or supplied by him to the Corporation for the purpose of notice. If the notice is sent by mail or by telegraph, it shall be deemed to have been given to the person entitled thereto when deposited in the United States mail or with a telegraph office for transmission to such person. A notice of a meeting shall specify the place, day and hour of the meeting.

SECTION 4.02        Waiver of Notice. Whenever any written notice is required to be given under the provisions of the articles, these Bylaws, or the Virginia Stock Corporation Act, a waiver thereof in writing, signed by the person or persons entitled to such notice, whether before or after the time stated therein, shall be deemed equivalent to the giving of such notice. Except in the case of a special meeting of shareholders, neither the business to be transacted at, nor the purpose of, the meeting need be specified in the waiver of notice of such meeting.

Attendance of a person, either in person or by proxy, or by a telephone conference arrangement which complies with Section 3.10 hereof, at any meeting, shall constitute a waiver of notice of such meeting, except where a person attends a meeting for the express purpose of objecting to the transaction of any business because the meeting was not lawfully called or convened.

## ARTICLE V

### Officers

SECTION 5.01        Number, Qualifications and Designation. The officers of the Corporation shall be a President, one or more Vice Presidents, a Secretary, a Treasurer, and such other officers as may be elected in accordance with the provisions of Section 5.03 of this Article. One person may hold more than one office. Officers may, but need not be, directors or shareholders of the Corporation. The Board of Directors may elect from among the members of the Board, a Chairman of the Board and Vice Chairman of the Board, neither of whom will be an officer of the Company, unless so designated by the Board.

SECTION 5.02        Election and Term of Office. The officers of the Corporation, except those elected by delegated authority pursuant to Section 5.03 of this Article, shall be elected annually by the Board of Directors, and each officer shall hold his office until the next annual organizational meeting of the Board of Directors and until his successor shall have been duly chosen and qualified, or until his death, resignation, or removal.

SECTION 5.03        Subordinate Officers, Committees and Agents. The Board of Directors may from time to time elect such other officers and appoint such committees, employees or other agents as the business of the Corporation may require, including one or more assistant secretaries, and one or more assistant treasurers, each of whom shall hold office for such period, have such authority, and perform such duties as are provided in these Bylaws, or as the Board of Directors may from time to time determine. The directors may delegate to any officer or committee the power to elect subordinate officers and to retain or appoint employees or other agents.

SECTION 5.04        Resignations. Any officer or agent may resign at any time by giving written notice to the Board of Directors, or to the President or the Secretary of the Corporation. Any such resignation shall take effect

at the date of the receipt of such notice or at any later time specified therein and, unless otherwise specified therein, the acceptance of such resignation shall not be necessary to make it effective.

SECTION 5.05        Removal. Any officer, member of a committee, employee or other agent of the Corporation may be removed, either for or without cause, by the Board of Directors or other authority which elected or appointed such officer, neither of a committee or other agent whenever in the judgment of such authority the best interests of the Corporation will be served thereby.

SECTION 5.06        Vacancies. A vacancy in any office because of death, resignation, removal, disqualification, or any other cause, shall be filled by the Board of Directors or by the officer or remaining members of the committee to which the power to fill such office has been delegated pursuant to Section 5.03 of this Article, as the case may be, and if the office is one for which these Bylaws prescribe a term, shall be filled for the unexpired portion of the term.

SECTION 5.07        General Powers. All officers of the Corporation as between themselves and the Corporation, shall, respectively, have such authority and perform such duties in the management of the property and affairs of the Corporation as may be determined by resolution of the Board of Directors, or in the absence of controlling provisions in a resolution of the Board of Directors, as may be provided in these Bylaws.

SECTION 5.08        The Chairman and Vice Chairman of the Board. The chairman of the Board or in his absence, the Vice Chairman of the Board, shall preside at all meetings of the shareholders and the Board of Directors, and shall perform such other duties as may from time to time be requested of him by the Board of Directors.

SECTION 5.09        The President. The President shall be the chief executive officer of the Corporation and shall have general supervision over the business and operation of the Corporation, subject, to the control of the Board of Directors. He shall sign, execute, and acknowledge, in the name of the Corporation, deeds, mortgages, bonds, contracts or other instruments, authorized by the Board of Directors, except in cases where the signing and execution thereof shall be expressly delegated by the Board of Directors, or by these Bylaws, to some other officer or agent of

the Corporation, and, in general, shall perform all duties incident to the office of President, and such other duties as from time to time may be assigned to him by the Board of Directors.

SECTION 5.10        The Vice Presidents. The Vice Presidents shall perform the duties of the President in his absence and such other duties as may from time to time be assigned to them by the Board of Directors or by the President.

SECTION 5.11        The Secretary. The Secretary or an assistant secretary shall attend all meetings of the shareholders and of the Board of Directors and shall record all the votes of the shareholders and of the directors and the minutes of the meetings of the shareholders and of the Board of Directors and of committees of the Board in a book or books to be kept for that purpose; shall see that notices are given and records and reports properly kept and filed by the Corporation as required by law; shall be the custodian of the seal of the Corporation and see that it is affixed to all documents to be executed on behalf of the Corporation under its seal; and, in general, shall perform all duties incident to the office of Secretary, and such other duties as may from time to time be assigned to him by the Board of Directors or the President.

SECTION 5.12        The Treasurer. The Treasurer or an assistant treasurer shall have or provide for the custody of the funds or other property of the corporation and shall keep a separate book account of the same to his credit as Treasurer; shall collect and receive or provide for the collection and receipts of monies earned by or in any manner due to or received by the Corporation; shall deposit all funds in his custody as Treasurer in such banks or other places of deposit as the Board of Directors may from time to time designate; shall, whenever so required by the Board of Directors, render an account showing his transactions as Treasurer and the financial condition of the Corporation; and, in general, shall discharge such other duties as may from time to time be assigned to him by the Board of Directors or the President.

SECTION 5.13        Officers' Bonds. Any officer shall give a bond for the faithful discharge of his duties in such sum, if any, and with such surety or sureties as the Board of Directors shall require.

SECTION 5.14        Salaries. The salaries of the officers elected by the Board of Directors shall be fixed from time to time by the Board of Directors or by such officer as may be designated by resolution of the Board. The



salaries or other compensation of any other officers, employees and other agents shall be fixed from time to time by the officer or committee to which the power to elect such officers or to retain or appoint such employees or other agents has been delegated pursuant to Section 5.03 of this Article. No officer shall be prevented from receiving such salary or other compensation by reason of the fact that he is also a director of the Corporation.

## ARTICLE VI

### Capital Stock

SECTION 6.01      Shares of Stock. The shares of all classes and series of stock of the Corporation may be certificated or uncertificated as provided under Virginia law, and shall be entered in the stock transfer books of the Corporation and registered as they are issued.

When shares of stock of the Corporation are represented by certificates, such certificates shall represent and certify the number and kind and class of shares owned by the shareholder in the Corporation and shall be in such form as may be required by law and approved by the Board of Directors. Each certificate shall be signed by the Chairman of the Board or the President or a Vice President and countersigned by the Secretary or an assistant secretary or the Treasurer or an assistant treasurer and may be sealed with the corporate seal or a facsimile thereof. The signatures of the officers upon a share certificate may be facsimiles if the certificate is countersigned by a transfer agent, or registered by a registrar, other than the Corporation itself or an employee of the Corporation. In case any officer who has signed any certificate ceases to be an officer of the Corporation before the certificate is issued, the certificate may nevertheless be issued by the Corporation with the same effect as if the officer had not ceased to be such officer as of the date of its issue. All certificates for the Corporation's shares shall be consecutively numbered or otherwise identified.

Each stock certificate shall include on its face (i) the name of the Corporation, (ii) that the Corporation is organized under the laws of the Commonwealth of Virginia, (iii) the name of the shareholder, (iv) the number and class or series, if any, of the shares represented by the certificate, and (v) any additional information required by the Virginia Stock Corporation Act to be included on certificates. If the Corporation has authority to issue stock of more than one class, or of more than one series within a class, the stock certificate shall contain on its face or back a full statement or summary of the designations and any preferences, conversion and other rights, voting powers, restrictions, limitations as to dividends, qualifications, and terms and conditions of redemption of the stock of each class which the Corporation

is authorized to issue and if the Corporation is authorized to issue any preferred or special class in series, the differences in the relative rights, preferences and limitations between the shares of each series to the extent they have been set, and the authority of the Board of Directors to set the relative rights and preferences of subsequent series. In lieu of such full statement or summary, there may be set forth upon the face or back of the certificate a statement that the Corporation will furnish to any shareholder upon request and without charge, a full statement of such information. A summary of such information included in a registration statement permitted to become effective under the federal Securities Act of 1933, as amended, shall be an acceptable summary for the purposes of this section. Every stock certificate representing shares of stock which are restricted as to transferability by the Corporation shall contain a full statement of the restriction or state that the Corporation will furnish information about the restriction to the shareholder on request and without charge. A stock certificate may not be issued until the stock represented by it is fully paid, except in the case of stock purchased under an option plan as permitted by law.

When shares of stock of the Corporation are not represented by certificates, then within a reasonable time after the issuance or transfer of such shares, the Corporation shall send, or cause to be sent, to the shareholder to whom such shares have been issued or transferred a written notice that shall set forth (i) the name of the Corporation, (ii) that the Corporation is organized under the laws of the Commonwealth of Virginia, (iii) the name of the shareholder, (iv) the number and class or series, if any, of the shares so held, and (v) any additional information required by the Virginia Stock Corporation Act to be included on certificates. If the Corporation has authority to issue stock of more than one class, or of more than one series within a class, the written notice shall contain the information required by the previous paragraph with respect to each class or series, or shall contain a statement that the Corporation will furnish such information to any shareholder upon request and without charge. In the event the shares are restricted as to transferability by the Corporation, then the written notice shall contain a full statement of the restriction or state that the Corporation will furnish information about the restriction to the shareholder on request and without charge.

Blank share certificates shall be kept by the Secretary or by a transfer agent or by a registrar or by any other officer or agent designated by the Board of Directors.

SECTION 6.02      Stolen, Lost or Destroyed Certificates. The Board of Directors may direct that a new certificate or certificates be issued, or evidence of the holder's ownership of shares in uncertificated form be delivered, in place of any certificate or certificates theretofore issued by the Corporation alleged to have been stolen, lost or

destroyed, upon the making of an affidavit of that fact by the person claiming the certificate of stock to be stolen, lost or destroyed. When authorizing such issuance of a new certificate or certificates or delivery of evidence of the holder's ownership of such shares in uncertificated form, the Board of Directors may, in its discretion and as a condition precedent to the issuance or delivery thereof, require the owner of such stolen, lost or destroyed certificate or certificates, or his legal representative, to advertise the same in such manner as it shall require, to give the Corporation a bond, with sufficient surety, to the Corporation to indemnify it against any loss or claim which may arise by reason of the issuance of a new certificate or delivery of evidence of the holder's ownership of such shares in uncertificated form, and to comply with any other terms the Board of Directors may lawfully prescribe.

SECTION 6.03        Transfer Agents and Registrars. At such time as the Corporation lists its securities on a national securities exchange, the Board of Directors shall appoint one or more transfer agents and/or registrars of the shares of stock of the Corporation; and, upon such appointments being made, no certificate representing shares shall be valid until countersigned by one of such transfer agents and registered by one of such registrars.

SECTION 6.04        Transfer of Stock. The Corporation, or its designated transfer agent or other agent, shall keep a book or set of books to be known as the stock transfer books of the Corporation, containing the name of each shareholder of record, together with such shareholder's address and the number and class or series of shares held by such shareholder. Such information may be stored or retained on discs, tapes, cards or any other approved storage device relating to data processing equipment; provided that such device is capable of reproducing all information contained therein in legible and understandable form, for inspection by shareholders or for any other corporate purpose.

No transfers of shares of stock of the Corporation shall be made if (i) void ab initio pursuant to any Article of the Corporation's Articles of Incorporation, (ii) the Board of Directors, pursuant to such Article, shall have refused to tender such shares, or (iii) the transferee is a nonresident alien individual or foreign entity. A permitted transfer of shares shall be made and recorded on the stock transfer books of the Corporation upon the receipt of proper transfer instructions as prescribed by the Board of Directors, the payment of all taxes thereon, and, in the case of transfers of shares which are represented by one or more certificates, only upon receipt of such certificate(s) with proper endorsement or duly executed stock transfer power, from the registered holder of record or from such holder's attorney thereunto

authorized by power of attorney duly executed and filed with the Secretary or with a transfer agent or transfer clerk. In the event a certificate representing shares to be transferred cannot be surrendered because it has been stolen, lost, or destroyed, the transferor shall comply with the requirements imposed by the Board of Directors as set forth in Section 6.02 of these Bylaws in lieu of surrendering a properly endorsed certificate. Upon satisfactory completion by the transferor of the requirements set forth in this Section 6.04, as to any transfer not prohibited by the Articles of Incorporation or by action of the Board of Directors thereunder, all certificates for the transferred shares shall be cancelled, new certificates representing the transferred shares (or evidence of the transferee's ownership of the transferred shares in uncertificated form) shall be delivered to the transferee, and the transaction shall be recorded on the stock transfer books of the Corporation. Except as otherwise provided by law, no transfer of shares shall be valid as against the Corporation, its shareholders or creditors, for any purpose, until it shall have been entered in the stock transfer books of the Corporation by an entry showing from and to whom transferred.

SECTION 6.05        Registered Shareholders. The Corporation shall be entitled to recognize the exclusive right of a person registered on its stock transfer books as the owner of shares (whether or not such shares are represented by certificates) to receive dividends, and to vote as such owner, and to hold liable for calls and assessments, if any, a person registered on its stock transfer books as the owner of shares, and shall not be bound to recognize any equitable or other claim to or interest in such share or shares on the part of any other person, whether or not it shall have express or other notice thereof, except as otherwise provided by law.

SECTION 6.06        Regulations. The Board of Directors may make such additional rules and regulations, not inconsistent with these Bylaws, as it may deem expedient concerning the issue, transfer and registration of shares of stock of the Corporation (whether or not such shares are represented by certificates).

## **ARTICLE VII**

### **Miscellaneous**

SECTION 7.01        Corporate Seal. The Corporation shall have a corporate seal in the form of a circle containing the name of the Corporation and such other details as may be required by the Board of Directors.

SECTION 7.02        Checks. All checks, notes, bills of exchange or other orders in writing shall be signed by such person or persons as the Board of Directors may from time to time designate.

SECTION 7.03        Contracts. Except as otherwise provided in these Bylaws, the Board of Directors may authorize any officer or officers, agent or agents, to enter into any contract or to execute or deliver any instrument on behalf of the Corporation, and such authority may be general or confined to specific instances.

SECTION 7.04        Deposits. All funds of the Corporation shall be deposited from time to time to the credit of the Corporation in such banks, trust companies, or other depositories as the Board of Directors may approve or designate, and all such funds shall be withdrawn only upon checks signed by such one or more officers or employees as the Board of Directors shall from time to time determine.

SECTION 7.05        Reports. The Board of Directors shall present at the annual meeting of shareholders a report of the financial condition of the Corporation as of the closing date of the preceding fiscal year. Such report shall be in such form as shall be approved by the Board of Directors and shall be available for inspection of shareholders at the annual meeting, but the Board of Directors shall not be required to cause such report to be sent to the shareholders.

SECTION 7.06        Corporate Records. There shall be kept at the principal office of the Corporation an original or duplicate record of the proceedings of the shareholders and of the directors, and the original or a copy of the Bylaws including all amendments or alterations thereto to date, certified by the Secretary. An original or duplicate stock transfer book shall also be kept at the registered office or principal place of business of the Corporation, or at the office of a transfer agent or registrar, giving the names of the shareholders, their respective addresses and the number and class of shares held by each. The Corporation shall also keep appropriate, complete and accurate books or records of account, which may be kept at its registered office or at its principal place of business.

SECTION 7.07        Amendment of Bylaws. These Bylaws may be amended or replaced, or new Bylaws may be adopted, either (1) by the vote of the shareholders entitled to cast at least a majority of the votes which all shareholders are entitled to cast thereon at any duly organized annual or special meeting of shareholders, or (2), with respect to those matters which are not by statute reserved exclusively to the shareholders, by vote of a majority of the Board of Directors, including a majority of the unaffiliated directors of the Corporation in office at any regular or special

meeting of directors. It shall not be necessary to set forth such proposed amendment, repeal or new Bylaws, or a summary thereof, in any notice of such meeting, whether annual, regular or special.

AMENDED: June 5, 2013

**Dynex Capital, Inc.**  
**2014 Base Salaries for Executive Officers**

The 2014 base salaries for Dynex Capital, Inc.'s executive officers are as follows: Thomas B. Akin, Executive Chairman -\$500,000; Byron L. Boston, Chief Executive Officer, President and Co-Chief Investment Officer-\$750,000; Stephen J. Benedetti, Executive Vice President, Chief Operating Officer and Chief Financial Officer-\$350,000; and Smriti L. Popenoe, Executive Vice President and Co-Chief Investment Officer-\$408,000.

**DYNEX CAPITAL, INC.**  
**LIST OF CONSOLIDATED ENTITIES**  
**As of December 31, 2013**

Investment Capital Access, Inc.  
Commercial Capital Access One, Inc.  
MERIT Securities Corporation  
Financial Asset Securitization, Inc.  
Issued Holdings Capital Corporation  
SMFC Funding Corporation

All companies were incorporated in Virginia.



**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Dynex Capital, Inc.  
Glen Allen, Virginia

We hereby consent to the incorporation by reference in the Registration Statements on Form S-3 (Nos. 333-22859, 333-10783, 333-10587, 333-172981 and 333-173551) and Form S-8 (Nos. 33-60282, 333-159426 and 333-159427) of Dynex Capital, Inc. of our reports dated March 4, 2014, relating to the consolidated financial statements, and the effectiveness of Dynex Capital, Inc.'s internal control over financial reporting, which appear in this Annual Report on Form 10-K.

BDO USA, LLP  
Richmond, Virginia

March 4, 2014

## CERTIFICATIONS

I, Byron L. Boston, certify that:

1. I have reviewed this Annual Report on Form 10-K of Dynex Capital, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 4, 2014

/s/ Byron L. Boston

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Byron L. Boston

Principal Executive Officer

## CERTIFICATIONS

I, Stephen J. Benedetti, certify that:

1. I have reviewed this Annual Report on Form 10-K of Dynex Capital, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 4, 2014

/s/ Stephen J. Benedetti

Stephen J. Benedetti

Principal Financial Officer

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER  
PURSUANT TO SECTION 906**

In connection with the Annual Report on Form 10-K of Dynex Capital, Inc. (the “Company”) for the fiscal year ended December 31, 2013, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), the undersigned, as the Principal Executive Officer of the Company and the Principal Financial Officer of the Company, respectively, certify, pursuant to and for purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to their knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 4, 2014

/s/ Byron L. Boston

Byron L. Boston

Principal Executive Officer

Date: March 4, 2014

/s/ Stephen J. Benedetti

Stephen J. Benedetti

Principal Financial Officer