Two Harbors Investment Corp.
Form 10-Q
August 03, 2012

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: June 30, 2012

Commission File Number 001-34506

TWO HARBORS INVESTMENT CORP.
(Exact Name of Registrant as Specified in Its Charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	27-0312904 (I.R.S. Employer Identification No.)
601 Carlson Parkway, Suite 150 Minnetonka, Minnesota (Address of Principal Executive Offices)	55305 (Zip Code)

(612) 629-2500
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of August 3, 2012 there were 279,354,704 shares of outstanding common stock, par value $.01 per share, issued and outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	June 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Available-for-sale securities, at fair value	$10,724,149	$6,249,252
Trading securities, at fair value	999,375	1,003,301
Mortgage loans held-for-sale, at fair value	11,378	5,782
Investment in real estate, net	71,726	—
Cash and cash equivalents	496,674	360,016
Restricted cash	138,336	166,587
Accrued interest receivable	35,954	23,437
Due from counterparties	81,039	32,587
Derivative assets, at fair value	361,073	251,856
Other assets	60,998	7,566
Total Assets	$12,980,702	$8,100,384
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	$10,438,441	$6,660,148
Derivative liabilities, at fair value	82,619	49,080
Accrued interest payable	11,545	6,456
Due to counterparties	166,949	45,565
Accrued expenses	11,164	8,912
Dividends payable	87,061	56,239
Income taxes payable	266	3,898
Total liabilities	10,798,045	6,830,298
Stockholders' Equity		
Preferred stock, par value $0.01 per share; 50,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, par value $0.01 per share; 450,000,000 shares authorized and 219,655,462 and 140,596,708 shares issued and outstanding, respectively	2,196	1,406
Additional paid-in capital	2,142,554	1,373,099
Receivable from issuance of common stock	(22,248)	—
Accumulated other comprehensive income (loss)	202,798	(58,716)
Cumulative earnings	233,256	157,452
Cumulative distributions to stockholders	(375,899)	(203,155)
Total stockholders' equity	2,182,657	1,270,086
Total Liabilities and Stockholders' Equity	$12,980,702	$8,100,384

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands, except share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(unaudited)		(unaudited)	
Interest income:				
Available-for-sale securities	$104,319	$39,959	$188,533	$59,494
Trading securities	1,250	805	2,300	1,077
Mortgage loans held-for-sale	126	—	195	—
Cash and cash equivalents	209	64	377	127
Total interest income	105,904	40,828	191,405	60,698
Interest expense	15,527	3,863	26,994	6,362
Net interest income	90,377	36,965	164,411	54,336
Other-than-temporary impairments:				
Total other-than temporary impairment losses	(4,476)	(294)	(8,751)	(294)
Non-credit portion of loss recognized in other comprehensive income	—	—	—	—
Net other-than-temporary credit impairment losses	(4,476)	(294)	(8,751)	(294)
Other income:				
Gain on investment securities, net	1,789	3,189	11,720	4,728
Loss on interest rate swap and swaption agreements	(61,014)	(50,808)	(77,207)	(48,869)
(Loss) gain on other derivative instruments	(7,617)	9,766	(16,507)	15,113
Other income	131	—	91	—
Total other loss	(66,711)	(37,853)	(81,903)	(29,028)
Expenses:				
Management fees	7,610	2,728	14,353	4,278
Other operating expenses	4,181	2,155	7,782	3,667
Total expenses	11,791	4,883	22,135	7,945
Income (loss) before income taxes	7,399	(6,065)	51,622	17,069
Benefit from income taxes	(16,605)	(5,081)	(24,182)	(4,324)
Net income (loss) attributable to common stockholders	$24,004	$(984)	$75,804	$21,393
Basic and diluted earnings (loss) per weighted average common share	$0.11	$(0.01)	$0.38	$0.35
Dividends declared per common share	$0.40	$0.40	$0.80	$0.80
Basic and diluted weighted average number of shares of common stock	214,810,579	77,101,606	200,833,084	61,443,978
Comprehensive income:				
Net income (loss)	$24,004	$(984)	$75,804	$21,393
Other comprehensive income:				
Unrealized gain on available-for-sale securities, net	117,604	14,514	261,514	23,629
Other comprehensive income	117,604	14,514	261,514	23,629
Comprehensive income	$141,608	$13,530	$337,318	$45,022

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TWO HARBORS INVESTMENT CORP.
CONDENDSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
(in thousands, except share data)

	Common Stock							
	Shares	Amount	Additional Paid-in Capital	Receivable from Issuance of Common Stock	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total Stockholders' Equity
					(unaudited)			
Balance, January 1, 2011	40,501,212	$405	$366,974	$—	$22,619	$30,020	$(37,570)	$382,448
Net income	—	—	—	—	—	21,393	—	21,393
Other comprehensive income	—	—	—	—	23,629	—	—	23,629
Net proceeds from issuance of common stock, net of offering costs	51,769,180	518	522,558	—	—	—	—	523,076
Common dividends declared	—	—	—	—	—	—	(53,112)	(53,112)
Non-cash equity award compensation	7,599	—	147	—	—	—	—	147
Balance, June 30, 2011	92,277,991	$923	$889,679	$—	$46,248	$51,413	$(90,682)	$897,581
Balance, January 1, 2012	140,596,708	$1,406	$1,373,099	$—	$(58,716)	$157,452	$(203,155)	$1,270,086
Net income	—	—	—	—	—	75,804	—	75,804
Other comprehensive income	—	—	—	—	261,514	—	—	261,514
Net proceeds from issuance of common stock, net of offering costs	79,058,754	790	769,022	—	—	—	—	769,812
Increase in receivable from issuance of	—	—	—	(22,248)	—	—	—	(22,248)

common stock								
Common dividends declared	—	—	—	—	—	—	(172,744)	(172,744)
Non-cash equity award compensation	—	—	433	—	—	—	—	433
Balance, June 30, 2012	219,655,462	$ 2,196	$ 2,142,554	$ (22,248)	$ 202,798	$ 233,256	$ (375,899)	$ 2,182,657

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Six Months Ended June 30, 2012 (unaudited)	2011
Cash Flows From Operating Activities:		
Net income	$75,804	$21,393
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of premiums and discounts on RMBS, net	(9,058)	4,693
Other-than-temporary impairment losses	8,751	294
Gain on investment securities, net	(11,720)	(4,728)
Loss on termination and option expiration of interest rate swaps and swaptions	18,540	227
Unrealized loss on interest rate swaps and swaptions	46,296	38,351
Unrealized gain on other derivative instruments	(4,773)	(5,893)
Unrealized gain on mortgage loans	(4)	—
Equity based compensation expense	433	147
Depreciation of real estate	32	—
Purchases of mortgage loans held-for-sale	(6,618)	—
Proceeds from repayment of mortgage loans held-for-sale	1,026	—
Net change in assets and liabilities:		
Increase in accrued interest receivable	(12,517)	(12,334)
Increase in deferred income taxes, net	(19,720)	(4,330)
Increase in current income tax receivable	(4,465)	—
(Increase)/decrease in prepaid and fixed assets	(554)	157
Increase in accrued interest payable, net	5,089	2,085
(Decrease)/increase in income taxes payable	(3,632)	5
Increase in accrued expenses	2,252	2,858
Net cash provided by operating activities	85,162	42,925
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	(4,696,861)	(3,338,528)
Proceeds from sales of available-for-sale securities	197,714	95,782
Principal payments on available-for-sale securities	295,829	116,651
Purchases of other derivative instruments	(205,440)	(165,831)
Proceeds from sales of other derivative instruments	69,699	19,572
Purchases of trading securities	(996,016)	(1,319,959)
Proceeds from sales of trading securities	1,001,904	500,133
Purchases of investments in real estate	(71,758)	—
Increase in escrow deposits	(28,693)	—
Increase (decrease) in due to counterparties, net	72,932	(19,866)
Decrease (increase) in restricted cash	28,251	(66,695)
Net cash used in investing activities	(4,332,439)	(4,178,741)

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, continued
(in thousands)

	Six Months Ended June 30,	
	2012	2011
	(unaudited)	
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	$23,100,723	$8,283,571
Principal payments on repurchase agreements	(19,322,430)	(4,626,172)
Proceeds from issuance of common stock, net of offering costs	769,812	523,076
Increase in receivable from issuance of common stock	(22,248)	—
Dividends paid on common stock	(141,922)	(26,650)
Net cash provided by financing activities	4,383,935	4,153,825
Net increase in cash and cash equivalents	136,658	18,009
Cash and cash equivalents at beginning of period	360,016	163,900
Cash and cash equivalents at end of period	$496,674	$181,909
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$10,438	$4,277
Cash paid for taxes	$3,635	$1
Non-Cash Financing Activity:		
Dividends declared but not paid at end of period	$87,061	$36,911
Reconciliation of mortgage loans held-for-sale:		
Mortgage loans held-for-sale at beginning of period	$5,782	$—
Purchases of mortgage loans held-for-sale	6,618	—
Proceeds from repayment of mortgage loans held-for-sale	(1,026)	—
Unrealized gain on mortgage loans	4	—
Loans held-for-sale at end of period	$11,378	$—

The accompanying notes are an integral part of these condensed consolidated financial statements.

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TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 1. Organization and Operations

Two Harbors Investment Corp., or the Company, is a Maryland corporation focused on investing in, financing and managing residential mortgage-backed securities, or RMBS, residential mortgage loans, residential real properties, and other financial assets. The Company is externally managed and advised by PRCM Advisers LLC, a subsidiary of Pine River Capital Management L.P., or Pine River, a global multi-strategy asset management firm. The Company's common stock is listed on the NYSE and its warrants are listed on the NYSE MKT under the symbols “TWO” and “TWO.WS,” respectively.

The Company has elected to be treated as a real estate investment trust, or REIT, for U.S. federal income tax purposes commencing with its initial taxable period ended December 31, 2009. As long as the Company continues to comply with a number of requirements under federal tax law and maintains is qualification as a REIT, the Company generally will not be subject to U.S. federal income taxes to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions. However, certain activities that the Company may perform may cause it to earn income which will not be qualifying income for REIT purposes. The Company has designated certain of its subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and the Company may in the future form additional TRSs.

Note 2. Basis of Presentation and Significant Accounting Policies

Consolidation and Basis of Presentation

The interim unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles, or GAAP, have been condensed or omitted according to such SEC rules and regulations. Management believes, however, that the disclosures included in these interim condensed consolidated financial statements are adequate to make the information presented not misleading. The accompanying condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at June 30, 2012 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2012 should not be construed as indicative of the results to be expected for the full year.

The condensed consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires us to make a number of significant estimates and assumptions. These estimates include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which the Company anticipates an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other estimates that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. The Company's estimates are inherently subjective in nature and actual results could differ from its estimates and the differences may be material.

The condensed consolidated financial statements of the Company include the accounts of all subsidiaries; inter-company accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

Significant Accounting Policies

Investment in Real Estate, Net

Beginning in early 2012, the Company began investing in single family residential properties with the intention of renting the properties. Real estate is recorded at acquisition cost, allocated between land and building. In making estimates of fair values for purposes of allocating purchase price, the Company utilizes information obtained from county tax assessment records to develop regional averages. Building depreciation is computed on the straight-line basis over the estimated useful lives of the assets. The Company generally uses a 27.5-year estimated life with no salvage value. For properties purchased subject to an existing lease, the assets are recorded at fair value, allocated to land, building and the existing lease. Any difference between fair value and cost is recorded in the income statement. The lease value is amortized over the expected benefit period (i.e., the lease term).

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TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

The Company evaluates its long-lived assets for impairment periodically or whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. If an impairment indicator exists, the Company compares the expected future undiscounted cash flows against the carrying amount of an asset. If the sum of the estimated undiscounted cash flows is less than the carrying amount of the asset, the Company would record an impairment loss for the difference between the estimated fair value and the carrying amount of the asset.

The lease periods are generally short term in nature (one year or less) and reflect market rental rates. Gross rental income and expenses applicable to rental income are reported in the statement of comprehensive income in other income and other operating expenses, respectively. Expenditures for ordinary maintenance and repairs are expensed to operations as incurred and expenditures for significant renovations that improve the asset and extend the useful life of the asset are capitalized and depreciated over their estimated useful life.

Refer to Note 2 to the Consolidated Financial Statements in the Company's 2011 Annual Report on Form 10-K regarding additional significant accounting policies.

Recently Issued and/or Adopted Accounting Standards

Comprehensive Income

In June 2011, the Financial Accounting Standards Board, or FASB, issued ASU No. 2011-05, which amends ASC 820, Comprehensive Income. The amendments are intended to make the presentation of items within Other Comprehensive Income (OCI) more prominent. ASU 2011-05 eliminates the option to present components of OCI in the statement of changes in stockholders' equity and requires companies to present all non-owner changes in stockholders' equity either as a single continuous statement of comprehensive income or as two separate but consecutive statements. In addition, reclassification adjustments between OCI and net income must be presented separately on the face of the financial statements. The new guidance does not change the components of OCI or the calculation of earnings per share. ASU 2011-05 is effective for the first interim or annual period beginning on or after December 15, 2011. Adopting this ASU did not have a material impact on the Company's condensed consolidated financial condition or results of operations. On December 23, 2011, the FASB issued ASU 2011-12, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. This was done to allow the FASB time to re-deliberate whether to present on the face of the financial statements the effects of reclassification out of accumulated OCI on the components of net income and comprehensive income for all periods presented. No other requirements under ASU 2011-05 are affected by this update.

Fair Value

In May 2011, the FASB issued ASU No. 2011-04, which amends ASC 820, Fair Value Measurements. The amendments in this ASU clarify the requirements for measuring fair value and disclosing information about fair value. It is intended to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with GAAP and International Financial Reporting Standards, or IFRS. The ASU is effective for the first interim or annual period beginning on or after December 15, 2011. Adopting this ASU did not have a material impact on the Company's condensed consolidated financial condition or results of operations.

Offsetting Assets and Liabilities

In December 2011, the FASB issued ASU No. 2011-11, which amends ASC 210, Balance Sheet. The amendments in this ASU enhance disclosures required by U.S. GAAP by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with ASC 210, Balance Sheet or ASC 815, Other Presentation Matters or (2) subject to an enforceable master netting arrangement or similar agreement. ASU 2011-11 is effective for the first interim or annual period beginning on or after January 1, 2013. We anticipate that adopting this ASU will not have a material impact on the Company's condensed consolidated financial condition or results of operations.

TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 3. Available-for-Sale Securities, at Fair Value
The following table presents the Company's available-for-sale, or AFS, investment securities by collateral type, which were carried at their fair value as of June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	$2,647,214	$1,609,003
Federal National Mortgage Association	4,412,010	2,414,637
Government National Mortgage Association	1,652,978	1,029,517
Non-Agency	2,011,947	1,196,095
Total mortgage-backed securities	$10,724,149	$6,249,252

At June 30, 2012 and December 31, 2011, the Company pledged investment securities with a carrying value of $10.5 billion and $6.2 billion, respectively, as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.
At June 30, 2012 and December 31, 2011, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, Transfers and Servicing, to be considered linked transactions and therefore classified as derivatives.
The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of June 30, 2012 and December 31, 2011:

	June 30, 2012		
(in thousands)	Agency	Non-Agency	Total
Face Value	$9,298,257	$4,291,928	$13,590,185
Unamortized premium	548,956	—	548,956
Unamortized discount			
Designated credit reserve	—	(1,322,098)	(1,322,098)
Net, unamortized	(1,351,394)	(944,298)	(2,295,692)
Amortized Cost	8,495,819	2,025,532	10,521,351
Gross unrealized gains	230,117	62,491	292,608
Gross unrealized losses	(13,734)	(76,076)	(89,810)
Carrying Value	$8,712,202	$2,011,947	$10,724,149

	December 31, 2011		
(in thousands)	Agency	Non-Agency	Total
Face Value	$5,692,754	$2,667,929	$8,360,683
Unamortized premium	279,640	—	279,640
Unamortized discount			
Designated credit reserve	—	(782,606)	(782,606)
Net, unamortized	(1,008,780)	(540,969)	(1,549,749)
Amortized Cost	4,963,614	1,344,354	6,307,968
Gross unrealized gains	108,864	11,881	120,745
Gross unrealized losses	(19,321)	(160,140)	(179,461)
Carrying Value	$5,053,157	$1,196,095	$6,249,252

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TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

The following tables present the carrying value of the Company's AFS investment securities by rate type as of June 30, 2012 and December 31, 2011:

	June 30, 2012		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$221,568	$1,750,513	$1,972,081
Fixed Rate	8,490,634	261,434	8,752,068
Total	$8,712,202	$2,011,947	$10,724,149

	December 31, 2011		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$231,678	$995,014	$1,226,692
Fixed Rate	4,821,479	201,081	5,022,560
Total	$5,053,157	$1,196,095	$6,249,252

When the Company purchases a credit-sensitive AFS security at a significant discount to its face value, the Company often does not amortize into income a significant portion of this discount that the Company is entitled to earn because it does not expect to collect it due to the inherent credit risk of the security. The Company may also record an other-than-temporary impairment, or OTTI, for a portion of its investment in the security to the extent the Company believes that the amortized cost will exceed the present value of expected future cash flows. The amount of principal that the Company does not amortize into income is designated as an off balance sheet credit reserve on the security, with unamortized net discounts or premiums amortized into income over time to the extent realizable.
The following table presents the changes for the six months ended June 30, 2012 and 2011 of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

	Six Months Ended June 30,					
	2012			2011		
(in thousands)	Designated Credit Reserve	Unamortized Net Discount	Total	Designated Credit Reserve	Unamortized Net Discount	Total
Beginning balance at January 1	$(782,606)	$(540,969)	$(1,323,575)	$(145,855)	$(129,992)	$(275,847)
Acquisitions	(553,552)	(479,435)	(1,032,987)	(249,153)	(168,684)	(417,837)
Accretion of net discount	250	62,768	63,018	—	12,409	12,409
Realized credit losses	17,908	—	17,908	1,242	—	1,242
Reclassification adjustment for other-than-temporary impairments	(8,751)	—	(8,751)	(294)	—	(294)
Transfers from (to)	—	—	—	66	(66)	—
Sales, calls, other	4,653	13,338	17,991	8,253	5,618	13,871
Ending balance at June 30	$(1,322,098)	$(944,298)	$(2,266,396)	$(385,741)	$(280,715)	$(666,456)

TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

The following table presents the components comprising the carrying value of AFS securities not deemed to be other than temporarily impaired by length of time the securities had an unrealized loss position as of June 30, 2012 and December 31, 2011. At June 30, 2012, the Company held 1,233 AFS securities, of which 194 were in an unrealized loss position for less than twelve consecutive months and 95 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2011, the Company held 854 AFS securities, of which 264 were in an unrealized loss position for less than twelve months and 20 were in an unrealized loss position for more than twelve consecutive months.

	Unrealized Loss Position for Less than 12 Months		12 Months or More		Total	
(in thousands)	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
June 30, 2012	$1,257,841	$(33,629)	$452,791	$(56,181)	$1,710,632	$(89,810)
December 31, 2011	$1,277,120	$(175,348)	$15,608	$(4,113)	$1,292,728	$(179,461)

Evaluating AFS Securities for Other-Than-Temporary Impairments

In order to evaluate AFS securities for OTTI, the Company determines whether there has been a significant adverse quarterly change in the cash flow expectations for a security. The Company compares the amortized cost of each security in an unrealized loss position against the present value of expected future cash flows of the security. The Company also considers whether there has been a significant adverse change in the regulatory and/or economic environment as part of this analysis. If the amortized cost of the security is greater than the present value of expected future cash flows using the original yield as the discount rate, 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. 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.

The Company recorded a $4.5 million and an $8.8 million other-than-temporary credit impairment during the three and six months ended June 30, 2012, respectively, on a total of 27 non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost. As of June 30, 2012, the impaired securities had weighted average cumulative losses of 1.1%, weighted average three-month prepayment speed of 2.17, weighted average 60+ day delinquency of 36.1% of the pool balance, and weighted average FICO score of 653. At June 30, 2012, the Company did not intend to sell the securities and determined that it was not more likely than not that the Company will be required to sell the securities, therefore, only the projected credit loss was recognized in earnings. During the three and six months ended June 30, 2011, the Company recorded a $0.3 million other-than-temporary credit impairment on one non-Agency RMBS where the future expected cash flows for each security was less than its amortized cost.

The following table presents the changes in OTTI included in earnings for six months ended June 30, 2012 and 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2012	2011	2012	2011
Cumulative credit loss at beginning of period	$(9,377)	$—	$(5,102)	$—
Additions:				
Other-than-temporary impairments not previously recognized	(2,644)	(294)	(6,128)	(294)
Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments	(1,832)	—	(2,623)	—

Reductions:				
Decreases related to other-than-temporary impairments on securities paid down	250	—	250	—
Cumulative credit loss at end of period	$(13,603)	$(294)	$(13,603)	$(294)

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Cumulative credit losses related to OTTI may be reduced for securities sold as well as securities that mature, pay down, or are prepaid such that the outstanding principal balance is reduced to zero. Additionally, increases in cash flows expected to be collected over the remaining life of the security cause a reduction in the cumulative credit loss.

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains (losses) within gain on investment securities, net in the Company's condensed consolidated statements of comprehensive income. For the three and six months ended June 30, 2012, the Company sold AFS securities for $27.6 million and $197.7 million with an amortized cost of $28.7 million and $187.7 million, for a net realized loss of $1.1 million and a net realized gain of $10.0 million, respectively.

The following table presents the gross realized gains and losses on sales of AFS securities for the three and six months ended June 30, 2012 and 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2012	2011	2012	2011
Gross realized gains	$560	$141	$11,663	$1,949
Gross realized losses	(1,629)	(95)	(1,629)	(265)
Total realized gains on sales, net	$(1,069)	$46	$10,034	$1,684

Note 4. Trading Securities, at Fair Value

The Company holds U.S. Treasuries in its taxable REIT subsidiary and classifies these securities as trading instruments due to its short-term investment objectives. As of June 30, 2012 and December 31, 2011, the Company held U.S. Treasuries with an amortized cost of $1.0 billion and $1.0 billion and a fair value of $1.0 billion and $1.0 billion, respectively, classified as trading securities. The unrealized gains included within trading securities were $3.0 million and $3.1 million as of June 30, 2012 and December 31, 2011, respectively.

For the three and six months ended June 30, 2012, the Company sold trading securities for $1.0 billion with an amortized cost of $1.0 billion resulting in realized gains of $1.7 million on the sale of these securities. For the three and six months ended June 30, 2012, trading securities experienced unrealized gains of $1.2 million and unrealized losses of $0.1 million, respectively. Both realized and unrealized gains and losses are recorded as a component of gains on investment securities, net in the Company's condensed consolidated statements of comprehensive income.

At June 30, 2012, the Company pledged trading securities with a carrying value of $1.0 billion as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.

Note 5. Mortgage Loans Held-for-Sale, at Fair Value

Mortgage loans held-for-sale consists of residential mortgage loans carried at fair value as a result of a fair value option election. The following table presents the carrying value of the Company's mortgage loans held-for-sale as of June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Unpaid principal balance	$11,093	$5,655
Fair value adjustment	285	127
Carrying value	$11,378	$5,782

At June 30, 2012, the Company pledged mortgage loans with a carrying value of $4.8 million as collateral for repurchase agreements. See Note 12 - Repurchase Agreements.

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Note 6. Investment in Real Estate, Net
Investments in real estate consists of single family residential properties purchased by the Company with the intention to hold and rent the properties. The following table presents the carrying value of the Company's investment in real estate as of June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Land	$15,106	$—
Building	56,652	—
	71,758	—
Accumulated depreciation	(32)	—
Investment in real estate, net	$71,726	$—

Note 7. Restricted Cash
The Company is required to maintain certain cash balances with counterparties for broker activity and collateral for the Company's repurchase agreements in non-interest bearing accounts. The Company has also placed cash in a restricted account pursuant to a letter of credit on an office space lease.
The following table presents the Company's restricted cash balances as of June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Restricted cash balances held by trading counterparties:		
For securities trading activity	$9,000	$9,000
For derivatives trading activity	114,064	62,784
As restricted collateral for repurchase agreements	14,926	94,803
	137,990	166,587
Restricted cash balance pursuant to letter of credit on office lease	346	—
Total	$138,336	$166,587

Note 8. Accrued Interest Receivable
The following table presents the Company's accrued interest receivable by collateral type:

(in thousands)	June 30, 2012	December 31, 2011
Accrued Interest Receivable:		
U.S. Treasuries	$1,101	$1,003
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	9,089	5,844
Federal National Mortgage Association	16,049	9,770
Government National Mortgage Association	6,869	4,454
Non-Agency	2,767	2,328
Total mortgage-backed securities	34,774	22,396
Mortgage loans held-for-sale	79	38
Total	$35,954	$23,437

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Note 9. Derivative Instruments and Hedging Activities
The Company enters into a variety of derivative and non-derivative instruments in connection with its risk management activities. The Company's primary objective for executing these derivatives and non-derivative instruments is to mitigate the Company's economic exposure to future events that are outside its control. The Company's derivative financial instruments are utilized principally to manage market risk and cash flow volatility associated with interest rate risk (including associated prepayment risk) related to certain assets and liabilities. As part of its risk management activities, the Company may, at times, enter into various forward contracts including short securities, Agency to-be-announced securities, or TBAs, options, futures, swaps, caps, and credit default swaps. In executing on the Company's current risk management strategy, the Company has entered into interest rate swap and swaption agreements, TBA positions and credit default swaps. The Company has also entered into a number of non-derivative instruments to manage interest rate risk, principally U.S. Treasuries and Agency interest-only securities.
The following summarizes the Company's significant asset and liability classes, the risk exposure for these classes, and the Company's risk management activities used to mitigate certain of these risks. The discussion includes both derivative and non-derivative instruments used as part of these risk management activities. While the Company uses non-derivative and derivative instruments to achieve the Company's risk management activities, it is possible that these instruments will not effectively mitigate all or a substantial portion of the Company's market rate risk. In addition, the Company might elect, at times, not to enter into certain hedging arrangements in order to maintain compliance with REIT requirements.
Balance Sheet Presentation
The following table presents the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading instruments as of June 30, 2012 and December 31, 2011.

(in thousands)	June 30, 2012				December 31, 2011			
	Derivative Assets		Derivative Liabilities		Derivative Assets		Derivative Liabilities	
Trading instruments	Fair Value	Notional	Fair Value	Notional	Fair Value	Notional	Fair Value	Notional
Inverse interest-only securities	$280,672	1,790,065	$—	—	$157,421	1,131,084	$—	—
Interest rate swap agreements	—	—	(71,793)	9,135,000	—	—	(28,790)	5,810,000
Credit default swap agreements	42,173	541,444	(10,826)	83,591	86,136	544,699	(14,638)	154,812
Swaptions	38,228	4,200,000	—	—	5,635	2,900,000	—	—
TBAs	—	—	—	—	2,664	275,000	(5,652)	850,000
Forward purchase commitment	—	32,406	—	—	—	—	—	—
Forward sale commitment	—	—	—	—	—	5,202	—	—
Total	$361,073	6,563,915	$(82,619)	9,218,591	$251,856	4,855,985	$(49,080)	6,814,812

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The following table provides the average outstanding notional amounts of the Company's derivative financial instruments treated as trading instruments for the three and six months ended June 30, 2012.

(in thousands)	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
Trading instruments	Derivative Assets	Derivative Liabilities	Derivative Assets	Derivative Liabilities
Inverse interest-only securities	1,727,601	—	1,529,218	—
Interest rate swap agreements	—	8,154,231	—	7,300,525
Credit default swaps	570,354	88,077	556,121	112,822
Swaptions	3,790,110	—	3,307,792	—
TBAs	324,176	945,055	267,265	854,420
Forward purchase commitment	1,480	—	601	—
Forward sale commitment	4,446	—	4,816	—

Comprehensive Income Statement Presentation
The Company has not applied hedge accounting to its current derivative portfolio held to mitigate the interest rate risk associated with its debt portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.
The following table summarizes the location and amount of gains and losses on derivative instruments reported in the condensed consolidated statement of comprehensive income on its derivative instruments:
(in thousands)

Trading Instruments	Location of Gain/(Loss) Recognized in Income on Derivatives	Amount of Gain/(Loss) Recognized in Income on Derivatives			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2012	2011	2012	2011
Risk Management Instruments					
Interest Rate Contracts					
Investment securities - RMBS	(Loss) gain on other derivative instruments	$(22,350)	$(381)	$(24,987)	$(639)
Investment securities - U.S. Treasuries and TBA contracts	(Loss) gain on interest rate swap and swaption agreements	(5,697)	(3,401)	(7,345)	(3,811)
Mortgage loans held-for-sale	(Loss) gain on other derivative instruments	(39)	—	(26)	—
Repurchase agreements	(Loss) gain on interest rate swap and swaption agreements	(55,317)	(47,407)	(69,862)	(45,058)
Credit default swaps - Receive protection	(Loss) gain on other derivative instruments	(1,225)	273	(25,526)	273
Non-Risk Management Instruments					
Credit default swaps - Provide protection	(Loss) gain on other derivative instruments	752	(3,513)	8,972	(1,175)
Inverse interest-only securities	(Loss) gain on other derivative instruments	15,245	13,387	25,060	16,654
Total		$(68,631)	$(41,042)	$(93,714)	$(33,756)

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For the three and six months ended June 30, 2012, the Company recognized $7.7 million and $12.4 million, respectively, of expenses for the accrual and/or settlement of the net interest expense associated with its interest rate swaps. The expenses result from generally paying a fixed interest rate on an average $8.2 billion and $7.3 billion notional, respectively, to hedge a portion of the Company's interest rate risk on its short-term repurchase agreements, funding costs, and macro-financing risk and generally receiving LIBOR interest.

For the three and six months ended June 30, 2012, the Company terminated or had options expire on a total of 8 and 19 interest rate swap and swaption positions of $2.0 billion notional and $2.9 billion notional, respectively. Upon settlement of the early terminations and option expirations, the Company paid $1.0 million and $1.5 million in full settlement of its net interest spread liability and recognized $7.3 million and $18.5 million in realized losses on the swaps and swaptions, respectively, including early termination penalties.

For the three and six months ended June 30, 2012, the Company terminated a total of 6 and 10 credit default swap positions totaling $155.0 million and $240.0 million notional, respectively. Upon settlement of the early terminations, the Company received $73,700 and $63,208 in full settlement of its net interest spread receivable and recognized $1.7 million and $3.3 million in realized losses on the credit default swaps, including early termination penalties.

Cash flow activity related to derivative instruments is reflected within the operating activities and investing activities sections of the condensed consolidated statements of cash flows. Derivative fair value adjustments are reflected within the unrealized loss (gain) on interest rate swaps and swaptions and unrealized loss (gain) on other derivative instruments line items and realized losses on interest rate swap and swaption agreements are reflected within the loss on termination of interest rate swaps and swaptions line item within the operating activities section of the condensed consolidated statements of cash flows. The remaining cash flow activity related to derivative instruments is reflected within the purchases of other derivative instruments, proceeds from sales of other derivative instruments and increase (decrease) in due to counterparties, net line items within the investing activities section of the condensed consolidated statements of cash flows.

Interest Rate Sensitive Assets/Liabilities

Available-for-sale Securities - The Company's RMBS investment securities are generally subject to change in value when mortgage rates decline or increase, depending on the type of investment. Rising mortgage rates generally result in a slowing of refinancing activity, which slows prepayments and results in a decline in the value of the Company's fixed-rate Agency pools. To mitigate the impact of this risk, the Company maintains a portfolio of financial instruments, primarily fixed-rate interest-only securities, which increase in value when interest rates increase. In addition, the Company has initiated TBA positions to further mitigate its exposure to increased prepayment speeds. The objective is to reduce the risk of losses to the portfolio caused by interest rate changes and changes in prepayment speeds.

As of June 30, 2012 and December 31, 2011, the Company had outstanding fair value of $61.2 million and $48.4 million, respectively, of interest-only securities in place to economically hedge its investment securities. These interest-only securities are included in AFS securities, at fair value, in the condensed consolidated balance sheets. The Company did not hold any long or short notional TBA positions as of June 30, 2012, but held TBA positions with $275.0 million in long notional and $850.0 million in short notional as of December 31, 2011, respectively. The Company discloses these on a gross basis according to the unrealized gain or loss position of each TBA contract regardless of long or short notional position. As of December 31, 2011, these contracts held a fair market value of $2.7 million, included in derivative assets, at fair value, and $5.7 million, included in derivative liabilities, at fair value, in the condensed consolidated balance sheet as of December 31, 2011.

Commitments to Purchase and/or Sell Mortgage Loans Held-for-Sale - Prior to a mortgage loan purchase, the Company may enter into forward purchase commitments with counterparties whereby the Company commits to purchasing the loans at a particular interest rate, provided the borrower elects to close the loan. These commitments to purchase mortgage loans have been defined as derivatives and are therefore recorded on the balance sheet as assets or liabilities and measured at fair value. Subsequent changes in fair value are recorded on the balance sheet as adjustments to the carrying value of these assets or liabilities with a corresponding adjustment recognized in current period earnings. As of June 30, 2012, the Company had entered into commitments to purchase mortgage loans of $32.4 million, subject to fallout if the loans do not close. No fair value was assigned to the derivative at June 30, 2012 as it was entered into at market terms at the end of the period.

The Company is exposed to interest rate risk on mortgage loans from the time it commits to purchase the mortgage loan until the mortgage loan is sold. Changes in interest rates impact the market price for the mortgage loans. For example, as market interest rates decline, the value of mortgage loans held-for-sale increases, and vice versa. To mitigate the impact of this risk, the Company may from time to time enter into a forward sale commitment under the Forward AAA Securities

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Agreement, or the Forward Agreement, with Barclays Bank PLC, or Barclays, pursuant to which Barclays would purchase certain securities issued in connection with a potential securitization transaction involving mortgage loans subject to the Forward Agreement. As of December 31, 2011, one trade had been executed under the Forward Agreement with a notional of $5.2 million. No fair value was assigned to the derivative at December 31, 2011 as it was entered into at market terms at the end of the year. This trade was settled by the Company in the three months ended June 30, 2012. As of June 30, 2012, the Company had no additional trades under the Forward Agreement.
Repurchase Agreements - The Company monitors its repurchase agreements, which are generally floating rate debt, in relationship to the rate profile of its investment securities. When it is cost effective to do so, the Company may enter into interest rate swap arrangements to align the interest rate composition of its investment securities and debt portfolios, specifically repurchase agreements with maturities of less than 6 months. Typically, the interest receivable terms (i.e., LIBOR) of the interest rate swaps match the terms of the underlying debt, resulting in an effective conversion of the rate of the related repurchase agreement from floating to fixed.
As of June 30, 2012 and December 31, 2011, the Company had the following outstanding interest rate swaps that were utilized as economic hedges of interest rate risk associated with the Company's short-term repurchase agreements:
(notional in thousands)
June 30, 2012

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2012	25,000	0.868	%	0.522	%	0.48
2013	2,275,000	0.713	%	0.500	%	1.06
2014	1,675,000	0.644	%	0.517	%	2.07
2015	2,070,000	1.039	%	0.447	%	2.87
2016 and Thereafter	2,090,000	1.053	%	0.476	%	4.28
Total	8,135,000	0.870	%	0.484	%	2.55

(notional in thousands)
December 31, 2011

Swaps Maturities	Notional Amount	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2012	25,000	0.868	%	0.315	%	0.98
2013	2,025,000	0.737	%	0.368	%	1.55
2014	1,275,000	0.670	%	0.380	%	2.72
2015	820,000	1.575	%	0.329	%	3.52
2016	240,000	2.156	%	0.316	%	4.32
Total	4,385,000	0.952	%	0.361	%	2.41

The Company has also entered into interest rate swaps in combination with U.S. Treasuries to economically hedge funding cost risk. As of June 30, 2012 and December 31, 2011, the Company held $1.0 billion in fair value of U.S. Treasuries classified as trading securities and the following outstanding interest rate swaps:
(notional in thousands)
June 30, 2012

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2015	1,000,000	0.799	%	0.476	%	2.78
Total	1,000,000					

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(notional in thousands)
December 31, 2011

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate	Average Receive Rate	Average Maturity (Years)
2013	1,250,000	0.620 %	0.339 %	1.54
Total	1,250,000			

As of June 30, 2012, all of the Company's interest rate swap contracts receive interest at a 1-month or 3-month LIBOR rate. As of December 31, 2011, all of the Company's interest rate swap contracts received interest at a 1-month or 3-month LIBOR rate, except the following interest rate swap entered in combination with TBA contracts to economically hedge mortgage basis widening where the Company paid interest at a 3-month LIBOR rate:
(notional in thousands)
December 31, 2011

Swaps Maturities	Notional Amounts	Average Pay Rate	Average Fixed Receive Rate	Average Maturity (Years)
2016	175,000	0.420 %	1.772 %	4.58
Total	175,000			

Additionally, as of June 30, 2012 and December 31, 2011, the Company had the following outstanding interest rate swaptions (agreements to enter into interest rate swaps in the future for which the Company would pay a fixed rate) that were utilized as macro-economic hedges:
June 30, 2012

(notional and dollars in thousands)	Option				Underlying Swap			
Swaption	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)
Payer	< 6 Months	$9,540	$3	3.38	1,000,000	2.95 %	3M Libor	5.4
Payer	≥ 6 Months	60,800	38,225	48.33	3,200,000	3.70 %	3M Libor	9.6
Total Payer		$70,340	$38,228	48.33	4,200,000	3.52 %	3M Libor	8.6

December 31, 2011

(notional and dollars in thousands)	Option				Underlying Swap			
Swaption	Expiration	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate	Average Receive Rate	Average Term (Years)
Payer	< 6 Months	$16,147	$4	4.97	1,600,000	3.22 %	3M Libor	3.7
Payer	≥ 6 Months	13,523	5,631	12.27	1,300,000	3.19 %	3M Libor	6.5
Total Payer		$29,670	$5,635	12.26	2,900,000	3.21 %	3M Libor	4.9

The Company has not applied hedge accounting to its current derivative portfolio held to mitigate the interest rate risk associated with its debt portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.
Foreign Currency Risk

In compliance with the Company's REIT requirements, the Company does not have exposure to foreign denominated assets or liabilities. As such, the Company is not subject to foreign currency risk.

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Credit Risk

The Company's exposure to credit losses on its U.S. Treasuries and Agency portfolio of investment securities is limited because these securities are issued by the U.S. Department of the Treasury or government sponsored entities, or GSEs. The payment of principal and interest on the Freddie Mac and Fannie Mae mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on the Ginnie Mae mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

For non-Agency investment securities, the Company enters into credit default swaps to hedge credit risk. In future periods, the Company could enhance its credit risk protection, enter into further paired derivative positions, including both long and short credit default swaps and/or seek opportunistic trades in the event of a market disruption (see "Non-Risk Management Activities" section). The Company also has processes and controls in place to monitor, analyze, manage and mitigate its credit risk with respect to non-Agency RMBS.

As of June 30, 2012, the Company held credit default swaps where the Company receives credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

The following tables present credit default swaps where the Company is receiving protection held as of June 30, 2012 and December 31, 2011:

(notional and dollars in thousands)
June 30, 2012

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable)/Receivable	Unrealized Gain/(Loss)
Receive	9/20/2013	460.00	(45,000)	$47	$ (3,127)	$(3,080)
	12/20/2013	181.91	(105,000)	479	(3,225)	(2,746)
	6/20/2016	105.50	(100,000)	(1,051)	(260)	(1,311)
	12/20/2016	682.82	(121,000)	4,360	(13,062)	(8,702)
	6/20/2017	586.18	(99,000)	3,190	(3,563)	(373)
	5/25/2046	356.00	(71,444)	35,148	(32,558)	2,590
	Total	365.95	(541,444)	$42,173	$ (55,795)	$(13,622)

(notional and dollars in thousands)
December 31, 2011

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable)/Receivable	Unrealized Gain/(Loss)
Receive	9/20/2013	460.00	(45,000)	$2,422	$ (3,127)	$(705)
	12/20/2013	172.50	(105,000)	3,742	(3,225)	517
	6/20/2016	105.00	(150,000)	2,074	(355)	1,719
	12/20/2016	684.38	(125,000)	10,200	(13,062)	(2,862)
	5/25/2046	377.23	(119,699)	67,698	(57,322)	10,376
	Total	341.94	(544,699)	$86,136	$ (77,091)	$9,045

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Derivative financial instruments contain an element of credit risk if counterparties are unable to meet the terms of the agreements. Credit risk associated with derivative financial instruments is measured as the net replacement cost should the counterparties that owe the Company under contracts completely fail to perform under the terms of these contracts, assuming there are no recoveries of underlying collateral, as measured by the market value of the derivative financial instruments. As of June 30, 2012, the fair value of derivative financial instruments as an asset and liability position was $361.1 million and $82.6 million, respectively.

The Company mitigates the credit risk exposure on derivative financial instruments by limiting the counterparties to those major banks and financial institutions that meet established credit guidelines, and the Company seeks to transact with several different counterparties in order to reduce the exposure to any single counterparty. Additionally, the Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties. The agreements require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. As of June 30, 2012, the Company has received cash deposits from counterparties of $34.2 million and placed cash deposits of $124.1 million in accounts maintained by counterparties, of which the amounts are netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the condensed consolidated balance sheet.

In accordance with ASC 815, as amended and interpreted, the Company records derivative financial instruments on its condensed consolidated balance sheet as assets or liabilities at fair value. Changes in fair value are accounted for depending on the use of the derivative instruments and whether they qualify for hedge accounting treatment. Due to the volatility of the credit markets and difficulty in effectively matching pricing or cash flows, the Company has elected to treat all current derivative contracts as trading instruments.

Non-Risk Management Activities

The Company has entered into certain financial instruments that are considered derivative contracts under ASC 815 that are not for purposes of hedging. These contracts are currently limited to inverse interest-only RMBS and credit default swaps.

Inverse interest-only securities with a carrying value of $280.7 million, including accrued interest receivable of $3.5 million, are accounted for as derivative financial instruments in the condensed consolidated financial statements. The following table presents the amortized cost and carrying value (which approximates fair value) of inverse interest-only securities as of June 30, 2012 and December 31, 2011:

(in thousands)	June 30, 2012	December 31, 2011
Face Value	$1,790,065	$1,131,084
Unamortized premium	—	—
Unamortized discount		
Designated credit reserve	—	—
Net, unamortized	(1,520,825)	(973,066)
Amortized Cost	269,240	158,018
Gross unrealized gains	15,138	4,606
Gross unrealized losses	(7,166)	(7,385)
Carrying Value	$277,212	$155,239

As of June 30, 2012 and December 31, 2011, the Company also held credit default swaps where the Company provides credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.

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The following tables present credit default swaps where the Company is providing protection held as of June 30, 2012 and December 31, 2011:
(notional and dollars in thousands)
June 30, 2012

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable)/Receivable	Unrealized Gain/(Loss)
Provide	7/25/2036	345.69	33,577	$2,186	$ (6,374)	$(4,188)
	5/25/2046	146.18	50,014	(13,012)	13,573	561
		226.32	83,591	$(10,826)	$ 7,199	$(3,627)

(notional and dollars in thousands)
December 31, 2011

Protection	Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront (Payable)/Receivable	Unrealized Gain/(Loss)
Provide	7/25/2036	358.71	99,890	$2,733	$ (11,089)	$(8,356)
	5/25/2046	146.18	54,922	(17,371)	13,574	(3,797)
		289.59	154,812	$(14,638)	$ 2,485	$(12,153)

Note 10. Other Assets
Other assets as of June 30, 2012 and December 31, 2011 are summarized in the following table:

(in thousands)	June 30, 2012	December 31, 2011
Property and equipment at cost	$632	$322
Accumulated depreciation [1]	(117)	(39)
Net property and equipment	515	283
Prepaid expenses	1,044	722
Current income tax receivable	4,622	157
Deferred tax assets	26,111	6,391
Escrow deposits	28,693	—
Lease deposit	13	13
Total other assets	$60,998	$7,566

(1) Depreciation expense for the three and six months ended June 30, 2012 was $44,586 and $77,768, respectively.

Note 11. Fair Value
Fair Value Measurements
ASC 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 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices available in active markets (i.e., observable inputs) and the lowest priority to data lacking transparency (i.e., unobservable inputs). Additionally, ASC 820 requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability.

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ASC 820 establishes a three level hierarchy to be used when measuring and disclosing fair value. An instrument's categorization within the fair value hierarchy is based on the lowest level of significant input to its valuation. Following is a description of the three levels:

Level 1	Inputs are quoted prices in active markets for identical assets or liabilities as of the measurement date under current market conditions. Additionally, the entity must have the ability to access the active market and the quoted prices cannot be adjusted by the entity.
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 that are observable or can be corroborated by observable market data by correlation or other means for substantially the full-term of the assets or liabilities.
Level 3	Unobservable inputs are supported by little or no market activity. The unobservable inputs represent the assumptions that market participants would use to price the assets and liabilities, including risk. Generally, Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation.

Following are descriptions of the valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized.
Investment securities - The Company holds a portfolio of AFS and trading securities that are carried at fair value in the condensed consolidated balance sheet. AFS securities are primarily comprised of Agency and non-Agency RMBS while the Company's U.S. Treasuries are classified as trading securities. The Company determines the fair value of its U.S. Treasuries and Agency RMBS based upon prices obtained from third-party pricing providers or broker quotes received using bid price, which are deemed indicative of market activity. In determining the fair value of its non-Agency RMBS, management judgment is used to arrive at fair value that considers prices obtained from third-party pricing providers, broker quotes received and other applicable market data. If observable market prices are not available or insufficient to determine fair value due to principally illiquidity in the marketplace, then fair value is based upon internally developed models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels, and credit losses). The Company classified 100.0% of its U.S. Treasuries as Level 1 fair value assets at June 30, 2012. The Company classified 100.0% of its RMBS AFS securities reported at fair value as Level 2 at June 30, 2012. AFS and trading securities account for 88.7% and 8.3% of all assets reported at fair value at June 30, 2012, respectively.
Mortgage loans held-for-sale - The Company holds a portfolio of mortgage loans held-for-sale that are carried at fair value in the condensed consolidated balance sheet as a result of a fair value option election. The Company determines fair value of its mortgage loans based on prices obtained from third-party pricing providers and other applicable market data. If observable market prices are not available or insufficient to determine fair value due principally to illiquidity in the marketplace, then fair value is based upon cash flow models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels and credit losses). The Company classified 100% of its mortgage loans held-for-sale as Level 2 fair value assets at June 30, 2012.
Derivative instruments - The Company may enter into a variety of derivative financial instruments as part of its hedging strategies. The Company principally executes over-the-counter, or OTC, derivative contracts, such as interest rate swaps. The Company utilizes internally developed models that are widely accepted in the market to value their OTC derivative contracts. The specific terms of the contract are entered into the model as well as market observable inputs such as interest rate forward curves and interpolated volatility assumptions. As all significant inputs into these models are market observable, the Company classified 100% of the interest rate swaps, swaptions and credit default swaps reported at fair value as Level 2 at June 30, 2012.

The Company also enters into certain other derivative financial instruments, such as TBAs and inverse interest-only securities. These instruments are similar in form to the Company's AFS securities and the Company utilizes broker quotes to value these instruments. The Company classified 100% of its inverse interest-only securities at fair value as Level 2 at June 30, 2012. The Company did not hold TBAs as of June 30, 2012.

The Company's risk management committee governs trading activity relating to derivative instruments. The Company's policy is to minimize credit exposure related to financial derivatives used for hedging by limiting the hedge counterparties to major banks, financial institutions, exchanges, and private investors who meet established capital and credit guidelines as well as by limiting the amount of exposure to any individual counterparty.

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The Company has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association, or ISDA. Additionally, both the Company and the counterparty are required to post cash collateral based upon the net underlying market value of the Company's open positions with the counterparty. Posting of cash collateral typically occurs daily, subject to certain dollar thresholds. Due to the existence of netting arrangements, as well as frequent cash collateral posting at low posting thresholds, credit exposure to the Company and/or to the counterparty is considered materially mitigated. Based on the Company's assessment, there is no requirement for any additional adjustment to derivative valuations specifically for credit.

The following tables display the Company's assets and liabilities measured at fair value on a recurring basis. The Company often economically hedges the fair value change of its assets or liabilities with derivatives and other financial instruments. The tables below display the hedges separately from the hedged items, and therefore do not directly display the impact of the Company's risk management activities.

	Recurring Fair Value Measurements At June 30, 2012			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	$—	$10,724,149	$—	$10,724,149
Trading securities	999,375	—	—	999,375
Mortgage loans held-for-sale	—	11,378	—	11,378
Derivative assets	—	361,073	—	361,073
Total assets	$999,375	$11,096,600	$—	$12,095,975
Liabilities				
Derivative liabilities	$—	$82,619	$—	$82,619
Total liabilities	$—	$82,619	$—	$82,619

	Recurring Fair Value Measurements At December 31, 2011			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	$—	$6,238,136	$11,116	$6,249,252
Trading securities	1,003,301	—	—	1,003,301
Mortgage loans held-for-sale	—	—	5,782	5,782
Derivative assets	2,664	249,192	—	251,856
Total assets	$1,005,965	$6,487,328	$16,898	$7,510,191
Liabilities				
Derivative liabilities	$5,652	$43,428	$—	$49,080
Total liabilities	$5,652	$43,428	$—	$49,080

The Company may be required to measure certain assets or liabilities at fair value from time to time. These periodic fair value measures typically result from application of certain impairment measures under GAAP. These items would constitute nonrecurring fair value measures under ASC 820. As of June 30, 2012, the Company did not have any assets or liabilities measured at fair value on a nonrecurring basis in the periods presented.

The valuation of Level 3 instruments requires significant judgment by the third-party pricing providers and/or management. The third party pricing providers and/or management rely on inputs such as market price quotations from market makers (either market or indicative levels), original transaction price, recent transactions in the same or similar instruments, and changes in financial ratios or cash flows to determine fair value. Level 3 instruments may also be discounted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the third party pricing provider in the absence of market information. Assumptions used by the third party pricing provider due to lack of observable inputs may significantly impact the resulting fair value and therefore the Company's financial statements. The

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Company's valuation committee reviews all valuations that are based on pricing information received from a third-party pricing provider. As part of this review, prices are compared against other pricing or input data points in the marketplace, along with internal valuation expertise, to ensure the pricing is reasonable. In addition, the Company performs back-testing of pricing information to validate price information and identify any pricing trends of a third party price provider.

In determining fair value, third party pricing providers use various valuation approaches, including market and income approaches. Inputs that are used in determining fair value of an instrument may include pricing information, credit data, volatility statistics, and other factors. In addition, inputs can be either observable or unobservable.

The availability of observable inputs can vary by instrument and is affected by a wide variety of factors, including the type of instrument, whether the instrument is new and not yet established in the marketplace and other characteristics particular to the instrument. The third party pricing provider uses prices and inputs that are current as of the measurement date, including during periods of market dislocations. In periods of market dislocation, the availability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified to or from various levels within the fair value hierarchy.

Securities for which market quotations are readily available are valued at the bid price (in the case of long positions) or the ask price (in the case of short positions) at the close of trading on the date as of which value is determined. Exchange-traded securities for which no bid or ask price is available are valued at the last traded price.

OTC derivative contracts, including interest rate swaps, are valued by the Company using observable inputs, such as quotations received from the counterparty, dealers or brokers, whenever available and considered reliable. In instances where models are used, the value of an OTC derivative depends upon the contractual terms of, and specific risks inherent in, the instrument as well as the availability and reliability of observable inputs. Such inputs include market prices for reference securities, yield curves, credit curves, volatility measures, prepayment rates and correlation of such inputs. Certain OTC derivatives, such as swaps, have inputs which can generally be corroborated by market data and are therefore classified within Level 2.

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The table below presents the reconciliation for all of the Company's Level 3 assets and liabilities measured at fair value on a recurring basis. The Level 3 items presented below may be hedged by derivatives and other financial instruments that are classified as Level 1 or Level 2. Thus, the table below does not fully reflect the impact of the Company's risk management activities.

	Level 3 Recurring Fair Value Measurements			
	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
	Assets		Assets	
(in thousands)	Available-For-Sale Securities	Mortgage Loans Held-For-Sale	Available-For-Sale Securities	Mortgage Loans Held-For-Sale
Beginning of period level 3 fair value	$—	$5,711	$11,116	$5,782
Gains/(losses) included in net income:				
Realized gains (losses)	—	—	—	—
Unrealized gains (losses)	—	—	—	(45) [1]
Total net gains/(losses) included in net income	—	—	—	(45)
Other comprehensive income	—	—	—	—
Purchases	—	—	—	—
Sales	—	—	—	—
Settlements	—	—	—	(26)
Gross transfers Into level 3	—	—	—	—
Gross transfers out of level 3	—	(5,711)	(11,116)	(5,711)
End of period level 3 fair value	$—	$—	$—	$—
Change in unrealized gains or losses for the period included in earnings for assets held at the end of the reporting period	$—	$—	$—	$—

(1) For the six months ended June 30, 2012 , the change in unrealized losses on mortgage loans held-for-sale was recorded in other income on the condensed consolidated statements of comprehensive income.

The Company transferred three Level 3 assets in the amount of $5.7 million and $16.8 million into Level 2 during the three and six months ended June 30, 2012, respectively. The assets were deemed to be Level 2 based on the availability of third-party pricing and corroborating market data. The Company did not incur transfers between Level 1 and Level 2 for the three and six months ended June 30, 2012. Transfers between Levels are deemed to take place on the first day of the reporting period in which the transfer has taken place.

Fair Value Option for Financial Assets and Financial Liabilities

The Company elected the fair value option for the residential mortgage loans it acquires. The fair value option was elected to mitigate earnings volatility by better matching the accounting for the assets with the related hedges. The residential mortgage loans are carried within mortgage loans held-for-sale on the condensed consolidated balance sheet. The Company's policy is to separately record interest income on these fair value elected loans. Upfront fees and costs related to the fair value elected loans are not deferred or capitalized. Fair value adjustments are reported in other income on the condensed consolidated statements of comprehensive income. The fair value option is irrevocable once the loan is acquired.

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The following table summarizes the fair value option elections and information regarding the amounts recognized in earnings for each fair value option-elected item.

	Changes included in the Condensed Consolidated Statements of Comprehensive Income	
	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
(in thousands)		
Interest income (1)	$126	$195
Gain on mortgage loans (2)	48	4
Total included in net income	$174	$199
Change in fair value due to credit risk	$—	$—

(1) Interest income on mortgage loans held-for-sale is measured by multiplying the unpaid principal balance on the loans by the coupon rate and the number of days of interest due.
(2) Gain on mortgage loans is recorded in other income on the condensed consolidated statements of comprehensive income.

The table below provides the fair value and the unpaid principal balance for the Company's fair value option-elected loans.

	June 30, 2012		December 31, 2011	
(in thousands)	Unpaid Principal Balance	Fair Value (1)	Unpaid Principal Balance	Fair Value (1)
Mortgage loans held-for-sale				
Total loans	$11,093	$11,378	$5,655	$5,782
Nonaccrual loans	$—	$—	$—	$—
Loans 90+ days past due	$—	$—	$—	$—

(1) Excludes accrued interest receivable.

Fair Value of Financial Instruments

In accordance with ASC 820, the Company is required to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the condensed consolidated balance sheet, for which fair value can be estimated.

The following describes the Company's methods for estimating the fair value for financial instruments. Descriptions are not provided for those items that have zero balances as of the current balance sheet date.

- AFS securities, trading securities, mortgage loans held-for-sale, derivative assets and liabilities are recurring fair value measurements; carrying value equals fair value. See discussion of valuation methods and assumptions within the Fair Value Measurements section of this footnote.
- Cash and cash equivalents and restricted cash have a carrying value which approximates fair value because of the short maturities of these instruments. The Company categorizes the fair value measurement of these assets as Level 1.
- The carrying value of repurchase agreements that mature in less than one year generally approximates fair value due to the short maturities. The Company holds $128.7 million of repurchase agreements that are considered long-term. The Company's long-term repurchase agreements have floating rates based on an index plus a spread. These borrowings have been recently entered into and the credit spread is typically consistent with those demanded in the market. Accordingly, the interest rates on these borrowings are at market and thus carrying value approximates fair

value. The Company categorizes the fair value measurement of these liabilities as Level 1.

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Note 12. Repurchase Agreements
The Company had outstanding $10.4 billion of repurchase agreements, including repurchase agreements funding the Company's U.S. Treasuries of $1.0 billion. Excluding the debt associated with the Company's U.S. Treasuries and the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 0.71% and weighted average remaining maturities of 86 days as of June 30, 2012. The Company had outstanding $6.7 billion of repurchase agreements with a weighted average borrowing rate of 0.78%, excluding the debt associated with the Company's U.S. Treasuries and the effect of the Company's interest rate swaps, and weighted average remaining maturities of 73 days as of December 31, 2011. As of June 30, 2012 and December 31, 2011, the debt associated with the Company's U.S. Treasuries had a weighted average borrowing rate of 0.24% and 0.12%, respectively.
At June 30, 2012 and December 31, 2011, the repurchase agreement balances were as follows:

(in thousands)	June 30, 2012	December 31, 2011
Short-term	$10,309,696	$6,610,148
Long-term	128,745	50,000
Total	$10,438,441	$6,660,148

At June 30, 2012 and December 31, 2011, the repurchase agreements had the following characteristics:

(dollars in thousands)	June 30, 2012		December 31, 2011	
Collateral Type	Amount Outstanding	Weighted Average Borrowing Rate	Amount Outstanding	Weighted Average Borrowing Rate
U.S. Treasuries	$997,500	0.24 %	$1,001,250	0.12 %
Agency RMBS	8,112,340	0.47 %	4,804,533	0.50 %
Non-Agency RMBS	1,121,990	2.38 %	731,014	2.61 %
Agency derivatives	202,247	1.16 %	118,032	0.97 %
Mortgage loans held-for-sale	4,364	2.50 %	5,319	3.20 %
Total	$10,438,441	0.67 %	$6,660,148	0.68 %

As of June 30, 2012, the amounts outstanding under repurchase agreements includes $99.1 million of borrowings under the 364-day repurchase facility with Wells Fargo Bank National Association, or Wells Fargo. As of June 30, 2012, the facility provided an aggregate maximum borrowing capacity of $150.0 million and was set to mature on July 25, 2012. The facility was renewed on July 24, 2012. The facility is collateralized by non-Agency RMBS and its weighted average borrowing rate as of June 30, 2012 was 1.98%. As of December 31, 2011, the amounts outstanding under repurchase agreements included $130.0 million of borrowings under the 364-day repurchase facility with Wells Fargo. As of December 31, 2011, the facility provided an aggregate maximum borrowing capacity of $150.0 million. The facility was collateralized by non-Agency RMBS and its weighted average borrowing rate as of December 31, 2011 was 2.07%. The facility requires the Company to maintain certain financial covenants under the guaranty agreement with Wells Fargo. As of June 30, 2012 and December 31, 2011, the Company was in compliance with these covenants.
As of June 30, 2012, the Company's amounts outstanding under repurchase agreements included $4.4 million of borrowings under the 364-day repurchase facility with Barclays. The facility provides an aggregate maximum borrowing capacity of $50.0 million and is set to mature on May 14, 2013, unless extended pursuant to its terms. The facility is collateralized by eligible residential mortgage loans and its weighted average borrowing rate as of June 30, 2012 was 2.50%. As of December 31, 2011, the Company's amounts outstanding under repurchase agreements included $5.3 million of borrowings under the 364-day repurchase facility with Barclays. As of December 31, 2011, the facility provided an aggregate maximum borrowing capacity of $100.0 million. The facility was collateralized by

eligible residential mortgage loans and its weighted average borrowing rate as of December 31, 2011 was 3.20%. The facility requires the Company to maintain certain financial covenants under the guaranty agreement with Barclays. As of June 30, 2012 and December 31, 2011, the Company was in compliance with these covenants.

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At June 30, 2012 and December 31, 2011, the repurchase agreements had the following remaining maturities:

(in thousands)	June 30, 2012	December 31, 2011
Within 30 days [(1)]	$3,167,682	$1,967,009
30 to 59 days	2,326,103	1,263,060
60 to 89 days	1,692,465	1,096,410
90 to 119 days	730,244	359,171
120 to 364 days [(2)]	1,395,702	923,248
Open maturity [(3)]	997,500	1,001,250
One year and over [(4)]	128,745	50,000
Total	$10,438,441	$6,660,148

(1) Within 30 days includes the amounts outstanding under the Wells Fargo 364-day borrowing facility.
(2) 120 to 364 days includes the amounts outstanding under the Barclays 364-day borrowing facility.
(3) Repurchase agreements collateralized by U.S. Treasuries include an open maturity period (i.e., rolling 1-day maturity) renewable at the discretion of either party to the agreements.
(4) One year and over includes repurchase agreements with maturity dates ranging from December 23, 2013 to June 26, 2015.

The following table summarizes assets at carrying value that are pledged or restricted as collateral for the future payment obligations of repurchase agreements:

(in thousands)	June 30, 2012	December 31, 2011
Available-for-sale securities, at fair value	$10,519,579	$6,160,229
Trading securities, at fair value	999,375	1,003,301
Mortgage loans held-for-sale	4,763	5,782
Cash and cash equivalents	12,248	15,000
Restricted cash	14,926	94,803
Due from counterparties	71,037	32,201
Derivative assets, at fair value	262,308	145,779
Total	$11,884,236	$7,457,095

Although the repurchase agreements are committed borrowings until maturity, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls.

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The following table summarizes certain characteristics of the Company's repurchase agreements and counterparty concentration at June 30, 2012 and December 31, 2011:

	June 30, 2012				December 31, 2011			
(dollars in thousands)	Amount Outstanding	Net Counterparty Exposure [1]	Percent of Equity	Weighted Average Days to Maturity	Amount Outstanding	Net Counterparty Exposure [1]	Percent of Equity	Weighted Average Days to Maturity
JP Morgan Chase [2]	$1,570,942	$271,942	12 %	68.2	$1,250,629	$184,046	14 %	70.0
Credit Suisse	274,994	231,437	11 %	30.4	95,691	46,006	4 %	14.1
All other counterparties [3]	7,595,005	957,999	44 %	91.0	4,312,578	567,440	45 %	75.1
Total	$9,440,941	$1,461,378			$5,658,898	$797,492		

(1) Represents the net carrying value of the securities sold under agreements to repurchase, including accrued interest plus any cash or assets on deposit to secure the repurchase obligation, less the amount of the repurchase liability, including accrued interest. At June 30, 2012 and December 31, 2011, the Company had $166.9 million and $45.6 million, respectively, in payables due to broker counterparties for unsettled securities purchases. The payables are not included in the amounts presented above.
(2) Excludes repurchase agreements collateralized by U.S. Treasuries with a rolling 1-day maturity.
(3) Represents amounts outstanding to 20 and 17 counterparties at June 30, 2012 and December 31, 2011, respectively.

The Company does not anticipate any defaults by its repurchase agreement counterparties.

Note 13. Stockholders' Equity

Distributions to stockholders

The following table presents cash dividends declared by the Company on its common stock from October 28, 2009 through June 30, 2012:

Declaration Date	Record Date	Payment Date	Cash Dividend Per Share
June 12, 2012	June 22, 2012	July 20, 2012	$0.40
March 14, 2012	March 26, 2012	April 20, 2012	$0.40
December 14, 2011	December 27, 2011	January 20, 2012	$0.40
September 14, 2011	September 26, 2011	October 20, 2011	$0.40
June 14, 2011	June 24, 2011	July 20, 2011	$0.40
March 2, 2011	March 14, 2011	April 14, 2011	$0.40
December 8, 2010	December 17, 2010	January 20, 2011	$0.40
September 13, 2010	September 30, 2010	October 21, 2010	$0.39
June 14, 2010	June 30, 2010	July 22, 2010	$0.33
March 12, 2010	March 31, 2010	April 23, 2010	$0.36
December 21, 2009	December 31, 2009	January 26, 2010	$0.26

Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) at June 30, 2012 and December 31, 2011 was as follows:

(in thousands)	June 30, 2012	December 31, 2011
Available-for-sale securities, at fair value		

Unrealized gains	$292,608	$120,745
Unrealized losses	(89,810)	(179,461)
Accumulated other comprehensive income (loss)	$202,798	$(58,716)

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Public offerings

On January 17, 2012, the Company completed a public offering of 34,000,000 shares of its common stock and issued an additional 5,100,000 shares of common stock pursuant to the underwriters' over-allotments at a price of $9.17 per share, for gross proceeds of approximately $358.5 million. On February 24, 2012, the Company completed a public offering of 30,000,000 shares of its common stock and issued an additional 4,500,000 shares of common stock pursuant to the underwriter's over-allotments at a price of $9.90 per share, for gross proceeds of approximately $341.6 million. Net proceeds to the Company from the two offerings were approximately $691.9 million, net of issuance costs of approximately $8.2 million.

Dividend Reinvestment and Direct Stock Purchase Plan

The Company sponsors a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of the Company's common stock by reinvesting some or all of the cash dividends received on shares of the Company's common stock. Stockholders may also make optional cash purchases of shares of the Company's common stock subject to certain limitation detailed in the plan prospectus. An aggregate of 7.5 million shares of our common stock have been reserved for issuance under the plan. As of June 30, 2012, 54,999 shares have been issued under the plan for total proceeds of $0.5 million.

Share Repurchase Program

On October 5, 2011, the Company's Board of Directors authorized a Share Repurchase Program, which allows the Company to repurchase up to 10,000,000 shares of its common stock. The shares are expected to be repurchased from time to time through privately negotiated transactions or open market transactions, pursuant to a trading plan in accordance with Rules 10b5-1 and 10b-18 under the Securities Exchange Act of 1934, as amended, or by any combination of such methods. The manner, price, number and timing of share repurchases will be subject to a variety of factors, including market conditions and applicable U.S. Securities and Exchange Commission rules. The Company did not repurchase any of its common stock during the fiscal year ended December 31, 2011 or the three and six months ended June 30, 2012.

At-the-Market Offering

On May 25, 2012, the Company entered into an Equity Distribution Agreement under which the Company may sell up to an aggregate of 20,000,000 shares of its common stock from time to time in any method permitted by law deemed to be an “at the market” offering as defined in Rule 415 under the Securities Act of 1933, as amended. During the three months ended June 30, 2012, the company sold 7.6 million shares of common stock for total accumulated net proceeds of approximately $77.6 million. As of June 30, 2012, 5.4 million shares were issued under the plan for total proceeds of $55.4 million. The remaining 2.2 million shares were issued in early July 2012 and the $22.2 million of receivable from issuance of common stock included in stockholders' equity on the condensed consolidated balance sheet as of June 30, 2012 was subsequently received.

Note 14. Other Operating Expenses

Components of the Company's other operating expenses for the three and six months ended June 30, 2012 and 2011 are presented in the following table:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Other operating expenses:				
General and administrative	$3,318	$1,527	$6,386	$2,632
Directors and officers' insurance	174	141	289	282
Professional fees	508	487	909	753
Real estate expenses	181	—	198	—
Total other operating expenses	$4,181	$2,155	$7,782	$3,667

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TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 15. Income Taxes
For the three and six months ended June 30, 2012 and 2011, the Company qualified to be taxed as a REIT under the Code for U.S. federal income tax purposes. As long as the Company qualifies as a REIT, the Company generally will not be subject to U.S. federal income taxes on its taxable income to the extent it annually distributes its net taxable income to stockholders, does not engage in prohibited transactions, and maintains its intended qualification as a REIT. The majority of states also recognize the Company's REIT status. The Company has two TRSs, Capitol Acquisition Corp., or Capitol, and TH TRS Corp., each of which file separate tax returns and are fully taxed as standalone U.S. C-Corporations. The tables below reflect the net taxes accrued at the TRS level and the tax attributes included in the condensed consolidated financial statements. It is assumed that the Company will retain its REIT status and will incur no REIT level taxation as it intends to comply with the REIT regulations and annual distribution requirements.
Certain activities the Company performs may produce income that will not be qualifying income for REIT purposes. These activities include holding swaptions, credit default swaps, TBAs and other risk-management instruments and has designated Capitol to engage in these activities. The Company purchases and intends to sell mortgage loans through the secondary whole loan market and/or securitization market and has designated TH TRS Corp. to engage in these activities.
The following table summarizes the tax (benefit) provision recorded at the taxable subsidiary level for the three and six months ended June 30, 2012 and 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2012	2011	2012	2011
Current tax provision (benefit):				
Federal	$3,753	$(264)	$(4,622)	$6
State	—	—	2	—
Total current tax provision (benefit)	3,753	(264)	(4,620)	6
Deferred tax benefit	(20,358)	(4,817)	(19,562)	(4,330)
Total benefit from income taxes	$(16,605)	$(5,081)	$(24,182)	$(4,324)

The Company's taxable income before dividend distributions differs from its GAAP pre-tax net income primarily due to unrealized gains and losses, the recognition of credit losses for GAAP but not tax, differences in timing of income recognition due to market discount, and original issue discount and the calculations surrounding each. These book to tax differences in the REIT are not reflected in the financial statements as the Company believes it will retain its REIT status.
The following is a reconciliation of the statutory federal and state rates to the effective rates, for the three and six months ended June 30, 2012 and 2011:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2012		2011		2012		2011	
(dollars in thousands)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Computed income tax expense (benefit) at federal rate	$2,516	34 %	$(2,062)	34 %	$17,552	34 %	$5,804	34 %
State taxes, net of federal benefit, if applicable	—	— %	—	— %	2	— %	—	— %
Permanent differences in taxable income from GAAP income (loss)	(9)	— %	3	— %	6	— %	4	— %

Dividends paid deduction	(19,112)	(258)%	(3,022)	(118)%	(41,742)	(81)%	(10,132)	(59)%
Benefit from income taxes/Effective Tax Rate[(1)]	$(16,605)	(224)%	$(5,081)	(84)%	$(24,182)	(47)%	$(4,324)	(25)%

(1) The benefit from income taxes is recorded at the taxable subsidiary level.

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The Company's condensed consolidated balance sheet, as of June 30, 2012 and December 31, 2011, contains the following current and deferred tax assets and liabilities, recorded at the taxable subsidiary level:

(in thousands)	June 30, 2012	December 31, 2011
Current tax		
Federal income tax payable	$—	$(3,898)
Current income taxes receivable	4,622	157
State and local income tax payable	—	—
Current tax receivable (payable), net	4,622	(3,741)
Deferred tax assets (liabilities)		
Deferred tax asset	27,220	9,710
Deferred tax liability	(1,109)	(3,319)
Deferred tax asset, net	26,111	6,391
Total tax assets and liabilities, net	$30,733	$2,650

Deferred Tax Assets and Liabilities
Deferred income taxes reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting and tax purposes. Components of the Company's deferred tax assets and liabilities as of June 30, 2012 and December 31, 2011 are as follows:

(in thousands)	June 30, 2012	December 31, 2011
Unrealized loss on derivative assets	$13,206	$7,429
Unrealized gain on trading securities and mortgage loans held-for-sale	(1,036)	(1,038)
Net operating loss carryforward	5,739	—
Capital loss carryforward	8,202	—
Total net deferred tax assets	$26,111	$6,391

At June 30, 2012 and December 31, 2011, the Company has not recorded a valuation allowance for any portion of its deferred tax assets as it does not believe, at a more likely than not level, that any portion of its deferred tax assets will not be realized. The net operating loss carryforward of $5.7 million is scheduled to expire December 31, 2032. The capital loss carryforward of $8.2 million is scheduled to expire December 31, 2017. The Company estimates, based on existence of sufficient evidence, the ability to realize the remainder of its deferred tax assets. Any adjustments to such estimates will be made in the period such determination is made.
Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's financial statements of a contingent tax liability for uncertain tax positions. Additionally, there were no amounts accrued for penalties or interest as of or during the periods presented in these condensed consolidated financial statements.

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Note 16. Earnings Per Share
The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted earnings per share, or EPS, for the three and six months ended June 30, 2012 and 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except share data)	2012	2011	2012	2011
Numerator:				
Net income (loss) attributable to common stockholders for basic and diluted earnings per share	$24,004	$(984)	$75,804	$21,393
Denominator:				
Weighted average common shares outstanding	214,764,586	77,042,875	200,784,364	61,388,974
Weighted average restricted stock shares	45,993	58,731	48,720	55,004
Basic and diluted weighted average shares outstanding	214,810,579	77,101,606	200,833,084	61,443,978
Basic and Diluted Earnings (Loss) Per Share:	$0.11	$(0.01)	$0.38	$0.35

For the three and six months ended June 30, 2012 and 2011, the Company has assumed that no warrants would be exercised as the weighted average market value per share of the Company's common stock was below the strike price of the warrants and the warrants would be anti-dilutive.

Note 17. Related Party Transactions
The following summary provides disclosure of the material transactions with affiliates of the Company.
In accordance with the Management Agreement with PRCM Advisers, the Company incurred $7.6 million and $14.4 million as a management fee to PRCM Advisers for the three and six months ended June 30, 2012, respectively, which represents approximately 1.5% of stockholders' equity on an annualized basis as defined by the Management Agreement. In addition, the Company reimbursed PRCM Advisers for direct and allocated costs incurred by PRCM Advisers on behalf of the Company. These direct and allocated costs totaled approximately $1.7 million and $6.1 million for the three and six months ended June 30, 2012, respectively.
During the three months ended June 30, 2012, the Company established an accounts payable function and direct relationships with the majority of its third party vendors. The Company will continue to have certain costs allocated to it by PRCM Advisers for compensation, data services and proprietary technology, but most direct expenses with third party vendors will be paid directly by the Company.
The Company recognized $373,276 and $433,346 of compensation expense during the three and six months ended June 30, 2012, respectively, associated with the amortization of shares of restricted stock issued to the Company's independent directors as part of their annual compensation.
As of June 30, 2012, there were 33,249,000 publicly-held registered warrants to purchase up to 33,249,000 shares of common stock issued and outstanding. Of the 33,249,000 warrants, 7,000,000 are beneficially owned by the founders of Capitol, and 2,906,918 are beneficially owned by Pine River Master Fund Ltd. and Nisswa Acquisition Master Fund Ltd., which are investment funds managed by Pine River. The Company is required to maintain a resale registration statement for the warrants and common stock issuable upon exercise thereof that are held by Pine River Master Fund Ltd., Nisswa Acquisition Master Fund Ltd., and the founders of Capitol.
On February 3, 2012, a subsidiary of the Company entered into an Acquisition Services Agreement, a Property Management Agreement and a side letter agreement regarding certain fees with Silver Bay Property Management LLC, or Silver Bay, which is a joint venture between Provident Real Estate Advisors LLC and an affiliate of PRCM Advisers and Pine River. Under the Acquisition Services Agreement, Silver Bay assists the Company's subsidiary in identifying and acquiring a portfolio of residential real properties in various geographic areas throughout the U.S.

Under the Property Management Agreement, Silver Bay operates, maintains, repairs, manages and leases the residential properties and collects rental income for the benefit of the Company and its affiliates. Pursuant to the side letter, the Company's subsidiary is obligated to pay Silver Bay for various services provided under the Acquisition Services and the Property Management Agreements. For the three and six months ended June 30, 2012, the Company incurred $1.0 million in acquisition fees to Silver Bay which were capitalized as part of the

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property acquisition cost. In addition, for the three and six months ended June 30, 2012, the Company incurred $43,114 in property management fees related to Silver Bay, of which $6,114 were expensed in the condensed consolidated statement of operations. The remaining $37,000 were deferred on the condensed consolidated balance sheet as of June 30, 2012 and will be amortized over the lease period.

Note 18. Subsequent Events

On July 18, 2012, the Company completed a public offering of 50,000,000 shares of its common stock and issued an additional 7,500,000 shares of common stock pursuant to the underwriters' over-allotments at a price of $10.44 per share, for gross proceeds of approximately $600.3 million. Net proceeds to the Company from the offering were approximately $592.4 million, net of issuance costs of approximately $7.9 million.

Events subsequent to June 30, 2012 were evaluated through the date these financial statements were issued and no additional events were identified requiring further disclosure in these Condensed Consolidated Financial Statements.

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

The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements and accompanying notes included elsewhere in this Quarterly Report on Form 10-Q as well as our Annual Report on Form 10-K for the year ended December 31, 2011.

General

We are a Maryland corporation focused on investing in, financing and managing residential mortgage-backed securities, or RMBS, residential mortgage loans, residential real properties and other financial assets. We operate as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code. We are externally managed by PRCM Advisers LLC. PRCM Advisers is a wholly-owned subsidiary of Pine River Capital Management L.P., or Pine River, a global asset management firm providing solutions to qualified clients across three actively managed platforms: hedge funds, managed accounts and listed investment vehicles.

Our objective is to provide attractive risk-adjusted returns to our stockholders over the long term, primarily through dividends and secondarily through capital appreciation. We selectively acquire and manage an investment portfolio of our target assets, which we believe is constructed to generate attractive returns through market cycles. Our target assets include the following:

- Agency RMBS, meaning RMBS whose principal and interest payments are guaranteed by the Government National Mortgage Association (or Ginnie Mae), the Federal National Mortgage Association (or Fannie Mae), or the Federal Home Loan Mortgage Corporation (or Freddie Mac);
- Non-Agency RMBS, meaning RMBS that are not issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac;
- Residential mortgage loans;
- Residential real properties; and
- Other financial assets comprising approximately 5% to 10% of the portfolio.

We believe our hybrid Agency and non-Agency RMBS investment model allows management to focus on security selection and implement a relative value investment approach across various sectors within the residential mortgage market, which factors in the displaced pricing opportunities in the marketplace, cost of financing and cost of hedging interest rate, prepayment, credit and other portfolio risks. As a result, RMBS asset allocation reflects management's opportunistic approach to investing in the marketplace.

For the three months ended June 30, 2012, we did not significantly modify our RMBS asset allocation between Agency and non-Agency RMBS. The following table provides the RMBS asset allocation between Agency and non-Agency RMBS as of June 30, 2012 and the four immediately preceding period ends:

	As of June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2011	June 30, 2011
Agency RMBS (1)	81.7 %	79.4 %	81.3 %	80.9 %	83.7 %
Non-Agency RMBS	18.3 %	20.6 %	18.7 %	19.1 %	16.3 %

(1) Agency RMBS includes inverse interest-only securities which are classified as derivatives for purposes of U.S. GAAP.

As our RMBS asset allocation shifts, our annualized yields and cost of financing shifts. As previously discussed, our investment decisions are not driven solely by annualized yields, but rather a multitude of macroeconomic drivers, including market environments and their respective impacts; for example, uncertainty of faster prepayments, extension risk and credit events.

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For the three months ended June 30, 2012, our net interest spread realized on Agency and non-Agency RMBS was slightly lower than prior periods. Based on recent experience, we believe that yields and net interest spreads on Agency and non-Agency RMBS securities are generally lower than what we have historically realized in our portfolio. The following table provides the average annualized yield on our Agency and non-Agency RMBS for the three months ended June 30, 2012, and the four immediately preceding quarters:

	Three Months Ended June 30, 2012		March 31, 2012		December 31, 2011		September 30, 2011		June 30, 2011	
Average annualized yields [(1)]										
Agency RMBS [(2)]	3.3	%	3.5	%	3.5	%	4.3	%	4.7	%
Non-Agency RMBS	9.6	%	9.7	%	9.7	%	9.8	%	8.8	%
Aggregate RMBS	4.6	%	4.9	%	4.8	%	5.5	%	5.4	%
Cost of financing [(3)]	1.0	%	1.0	%	1.0	%	1.3	%	1.3	%
Net interest spread	3.6	%	3.9	%	3.8	%	4.2	%	4.1	%

(1) Average annualized yield incorporates future prepayment, credit loss and other assumptions, all of which are estimates and subject to change.
(2) Agency RMBS includes inverse interest-only securities which are classified as derivatives under U.S. GAAP.
(3) Cost of financing includes swap interest rate spread.

The following table provides the average annualized yield on our Agency and non-Agency RMBS as of June 30, 2012, and the four immediately preceding period ends:

	As of June 30, 2012		March 31, 2012		December 31, 2011		September 30, 2011		June 30, 2011	
Average annualized yields [(1)]										
Agency RMBS [(2)]	3.3	%	3.5	%	3.3	%	3.4	%	3.9	%
Non-Agency RMBS	9.6	%	9.7	%	9.7	%	9.6	%	9.2	%
Aggregate RMBS	4.5	%	4.7	%	4.7	%	4.7	%	4.8	%
Cost of financing [(3)]	1.0	%	1.0	%	1.0	%	1.3	%	1.3	%
Net interest spread	3.5	%	3.7	%	3.7	%	3.4	%	3.5	%

(1) Average annualized yield incorporates future prepayment, credit loss and other assumptions, all of which are estimates and subject to change.
(2) Agency RMBS includes inverse interest-only securities which are classified as derivatives for purposes of U.S. GAAP.
(3) Cost of financing includes swap interest rate spread.

We seek to deploy moderate leverage as part of our investment strategy. We generally finance our RMBS assets through short-term borrowings structured as repurchase agreements. Our Agency RMBS and Agency derivatives, given their liquidity and high credit quality, are eligible for higher levels of leverage, while non-Agency RMBS, with less liquidity and exposure to credit risk, utilize lower levels of leverage. We also finance our U.S. Treasuries, which we hold for trading purposes, and our mortgage loans. We believe the debt-to-equity ratio funding our RMBS, Agency derivatives and residential mortgage loans is the most meaningful leverage measure as U.S. Treasuries are viewed to be highly liquid in nature. As a result, our debt-to-equity ratio is determined by our RMBS portfolio mix as well as many additional factors, including the liquidity of our portfolio, the sustainability and price of our financing, diversification of our counterparties and their available capacity to finance our RMBS assets, and anticipated regulatory developments. Over the past several quarterly periods, we have generally maintained a debt-to-equity ratio range of 3.0 to 5.0 times to finance our RMBS, Agency derivatives and mortgage loans, on a fully deployed capital basis. Our debt-to-equity ratio is directly correlated to the make-up of our RMBS portfolio; specifically, the higher percentage of Agency RMBS we hold, the higher our debt-to-equity ratio is, and vice versa. We may alter the percentage allocation of our portfolio between Agency and non-Agency RMBS depending on the quality of the assets that are available to purchase from time to time, including at times when we are deploying proceeds from common stock offerings we conduct. The debt-to-equity ratio range has been driven by our relatively stable asset allocation between Agency and non-Agency RMBS, as disclosed above. See the

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section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Financial Condition -- Repurchase Agreements" for further discussion.

We compete with other investment vehicles for attractive investment opportunities. We rely on our management team and Pine River, who have developed strong relationships with a diverse group of financial intermediaries, to identify investment opportunities. In addition, we have benefited and expect to continue to benefit from Pine River's analytical and portfolio management expertise and infrastructure. We believe that our significant focus on the RMBS area, the extensive RMBS expertise of our investment team, our strong analytics and our disciplined relative value investment approach give us a competitive advantage versus our peers.

We have elected to be treated as a REIT for U.S. federal income tax purposes. To qualify as a REIT we are required to meet certain investment and operating tests and annual distribution requirements. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to stockholders, do not participate in prohibited transactions and maintain our intended qualification as a REIT. However, certain activities that we may perform may cause us to earn income which will not be qualifying income for REIT purposes. We have designated certain of our subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities, and we may form additional TRSs in the future. We also operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940, as amended, or the 1940 Act.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains, or incorporates by reference, not only historical information, but also forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, as amended. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as “anticipate,” “estimate,” “will,” “should,” “expect,” “target,” “believe,” “intend,” “plan” and similar expressions or their negative forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this Annual Report on Form 10-K under the caption “Risk Factors.” Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update or revise any such forward-looking statements, whether as a result of new information, future events, or otherwise.

Important factors, among others, that may affect our actual results include:

- changes in interest rates and the market value of our target assets;
- changes in prepayment rates of mortgages underlying our target assets;
- the timing of credit losses within our portfolio;
- our exposure to adjustable-rate and negative amortization mortgage loans underlying our target assets;
- the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers;
- the concentration of the credit risks we are exposed to;
- legislative and regulatory actions affecting the mortgage and derivative industries or our business;
- the availability of target assets for purchase at attractive prices;
- the availability of financing for our portfolio, including the availability of repurchase agreement financing;
- declines in home prices;
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- increases in payment delinquencies and defaults on the mortgages underlying our Non-Agency securities;
- changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale;
- changes in the values of securities we own and the impact of adjustments reflecting those changes on our income statement and balance sheet, including our stockholders' equity;
- our ability to generate the amount of cash flow we expect from our investment portfolio;
- changes in our investment, financing, and hedging strategies and the new risks that those changes may expose us to;

- changes in the competitive landscape within our industry, including changes that may affect our ability to retain or attract personnel;
- our ability to build successful relationships with loan originators;
- our ability to acquire mortgage loans in connection with our securitization plans;
- our ability to securitize the mortgage loans that we acquire;
- our ability to acquire residential real properties at attractive prices and lease such properties on a profitable basis or to resell such properties at a gain;
- our ability to manage various operational risks associated with our business;
- our ability to maintain appropriate internal controls over financial reporting;
- our ability to establish, adjust and maintain appropriate hedges for the risks in our portfolio;
- our ability to maintain our REIT qualification for U.S. federal income tax purposes; and
- limitations imposed on our business due to our REIT status and our status as exempt from registration under the 1940 Act.

This Quarterly Report on Form 10-Q may contain statistics and other data that in some cases have been obtained or compiled from information made available by mortgage loan servicers and other third-party service providers.

Factors Affecting our Operating Results

Our net interest income includes income from our RMBS portfolio and will reflect the amortization of purchase premiums and accretion of purchase discounts. Net interest income will fluctuate primarily as a result of changes in market interest rates, our financing costs, and prepayment speeds on our assets. Interest rates, financing costs and prepayment rates vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. Our operating results will also be affected by default rates and credit losses with respect to the mortgage loans underlying our non-Agency RMBS.

Fair Value Measurement

ASC 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 willing market participants at the measurement date. It also establishes three levels of input to be used when measuring fair value:

Level 1	Inputs are quoted prices in active markets for identical assets or liabilities as of the measurement date under current market conditions. Additionally, the entity must have the ability to access the active market and the quoted prices cannot be adjusted by the entity.
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 that are observable or can be corroborated by observable market data by correlation or other means for substantially the full-term of the assets or liabilities.
Level 3	Unobservable inputs are supported by little or no market activity. The unobservable inputs represent the assumptions that market participants would use to price the assets and liabilities, including risk. Generally, Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation.

We follow the fair value hierarchy set forth above in order to prioritize the data utilized to measure fair value. We strive to obtain quoted market prices in active markets (Level 1 inputs). If Level 1 inputs are not available, we will attempt to obtain Level 2 inputs, observable market prices in inactive markets or derive the fair value measurement using observable market prices for similar assets or liabilities. When neither Level 1 nor Level 2 inputs are available, we use Level 3 inputs and independent pricing service models to estimate fair value measurements. At June 30, 2012, approximately 93.2% of total assets, or $12.1 billion, and approximately 0.8% of total liabilities, or $82.6 million, consisted of financial instruments recorded at fair value. As of June 30, 2012, we had no assets or liabilities reported at fair value using Level 3 inputs. See Note 10 - Fair Value to the Condensed Consolidated Financial Statements, included in this Quarterly Report on Form 10-Q, for descriptions of valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized.

A significant portion of our assets and liabilities are at fair value and, therefore, our condensed consolidated balance sheet and income statement are significantly affected by fluctuations in market prices. Although we execute various hedging strategies to mitigate our exposure to changes in fair value, we cannot fully eliminate our exposure to volatility caused by fluctuations in market prices. Starting in 2007, markets for asset-backed securities, including RMBS, have experienced severe dislocations. While these market disruptions continue, our assets and liabilities will be subject to valuation adjustment as well as changes in the inputs we use to measure fair value.

For the three and six months ended June 30, 2012, our unrealized fair value losses on interest rate swap and swaption agreements, which are accounted for as derivative trading instruments under GAAP, negatively affected our financial results. The change in fair value of the interest rate swaps was a result of changes to LIBOR, the swap curve, and corresponding counterparty borrowing rates during the three and six months ended June 30, 2012. Our financial results for the three months ended June 30, 2012 were positively affected by unrealized fair value gains on certain U.S. Treasuries classified as trading instruments due to their short-term investment objectives, while, for the six months ended June 30, 2012, our unrealized fair value losses on U.S. Treasuries classified as trading instruments negatively affected our financial results. For the three and six months ended June 30, 2011, our unrealized fair value losses on interest rate swap and swaption agreements, which are accounted for as derivative trading instruments under GAAP, negatively affected our financial results. The change in fair value of the interest rate swaps was a result of decreases in the swap curve during the three and six months ended June 30, 2011. Our financial results for the three and six months ended June 30, 2011 were positively affected by unrealized fair value gains on certain U.S. Treasuries classified as trading instruments. In addition, our financial results for the three and six months ended June 30, 2012 and 2011 were affected by the unrealized gains and losses of certain other derivative instruments that were accounted for as trading derivative instruments, i.e., credit default swaps, TBAs and inverse interest-only securities. Any temporary change in the fair value of our available-for-sale securities is recorded as a component of accumulated other comprehensive income and does not impact our earnings.

We have numerous internal controls in place to help ensure the appropriateness of fair value measurements. Significant fair value measures are subject to detailed analytics and management review and approval. Our entire investment portfolio is priced by third-party brokers at the “bid side” of the market, and/or by independent pricing providers. We strive to obtain multiple market data points for each valuation. By utilizing “bid side” pricing, certain assets, especially the most recent purchases, may realize a markdown due to the “bid-offer” spread. To the extent that this occurs, any economic effect of this would be reflected in accumulated other comprehensive income. We back test the fair value measurements provided by the pricing providers against actual performance. We also monitor the market for recent trades, market surveys, or other market information that may be used to benchmark pricing provider inputs.

Considerable judgment is used in forming conclusions and estimating inputs to our Level 3 fair value measurements. Level 3 inputs such as interest rate movements, prepayments speeds, credit losses and discount rates are inherently difficult to estimate. Changes to these inputs can have a significant effect on fair value measurements. 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.

Market Conditions and Outlook

The first six months of 2012 continued to produce a number of regulatory actions in an effort to stabilize economic conditions and increase liquidity in the financial markets as well as other actions related to the fall-out from the financial and foreclosure crises. Regulatory actions that could impact the value of our RMBS, either positively or negatively, include attempts by the Obama Administration to streamline further the refinancing process to allow more borrowers to refinance into lower interest rate mortgage loans (see President Obama's address in early January); the announcement by the Federal Reserve of its intention to keep the Federal Funds Target Rate near zero through late-2014; the possibility of an REO-to-Rental program supported by the GSEs; an expansion of the HAMP refinancing program to include borrowers whose loans are not in GSE pools; and the Federal Reserve's Operation Twist. Additionally, the U.S. economy continues to be burdened by the European debt crisis, stagnating unemployment numbers and a struggling housing market, which, despite signs of an approaching recovery, remains weighted with backlogs of homes in the foreclosure process as servicers evaluate the impacts of the proposed settlement with State Attorneys General over improper foreclosure practices and the adoption by several states of various legislation aimed at curtailing or modifying the foreclosure process. Events such as these will continue to affect our portfolio.

We believe our blended Agency and non-Agency strategies and our investing expertise will allow us to better navigate the dynamic characteristics of the RMBS environment while GSE reform and any other future regulatory efforts take shape. Having a diversified portfolio allows us to mitigate risks, including the volatility and impacts generated by uncertainty in interest rates and changes in prepayments, home prices and homeowner default rates.

We expect that the majority of our assets will remain in whole-pool Agency RMBS in light of the long-term attractiveness of the asset class and in order to continue to satisfy the requirements of our exemption from registration under the 1940 Act. Interest-only Agency securities also provide a complementary investment and risk-management strategy to our principal and interest Agency RMBS investments. Risk-adjusted returns in our Agency RMBS portfolio may decline if we are required to pay higher purchase premiums due to lower interest rates or additional liquidity in the market.

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The following table provides the carrying value of our RMBS portfolio by product type:

(dollars in thousands)	June 30, 2012			December 31, 2011		
Agency						
Fixed Rate	$8,490,634	79.2	%	$4,821,479	77.2	%
Hybrid ARMs	221,568	2.1	%	231,678	3.7	%
Total Agency	8,712,202	81.3	%	5,053,157	80.9	%
Non-Agency						
Senior	1,591,438	14.8	%	932,867	14.9	%
Mezzanine	416,439	3.9	%	262,633	4.2	%
Interest-only securities	4,070	—	%	595	—	%
Total Non-Agency	2,011,947	18.7	%	1,196,095	19.1	%
Total	$10,724,149			$6,249,252		

Prepayment speeds and volatility due to interest rates

Our Agency RMBS portfolio is subject to inherent prepayment risk: generally, a decline in interest rates that leads to rising prepayment speeds will cause the market value of our interest-only securities to deteriorate, but will cause the market value of our fixed coupon Agency pools to increase. The inverse relationship occurs when interest rates increase and prepayments slow. We do not expect housing prices to fully stabilize in 2012 and this, combined with elevated unemployment rates and housing inventory increases, leads us to expect that there will not be a significant increase in prepayment speeds in 2012. However, given the low level of interest rates, the implementation of Operation Twist, and the announcement of HARP 2.0, the revamped Home Affordable Refinance Program, or other potential government programs, it is possible that prepayment speeds will increase on many RMBS, which could lead to less attractive reinvestment opportunities. Nonetheless, we believe our portfolio approach, including our security selection process, is well positioned to respond to a variety of market scenarios, including an overall faster prepayment environment.

Although we are unable to predict the movement in interest rates for the remainder of 2012 and beyond, our blended Agency and non-Agency portfolio strategy is intended to generate attractive yields with a low level of sensitivity to yield curve, prepayments and interest rate cycles.

Our portfolio includes Agency securities, which includes bonds with explicit prepayment protection, lower loan balances (securities collateralized by loans of less than $175,000 in principal), high loan-to-value (or LTV) ratios (securities collateralized by loans with greater or equal to 80% LTV), low FICO scores (lower credit borrowers), home equity conversion mortgages (securities collateralized by reverse mortgages), and seasoned bonds reflecting less prepayment risk due to previously experienced high levels of refinancing. We believe these bond characteristics reduce the prepayment risk to the portfolio.

The following tables provide the carrying value of our Agency RMBS portfolio by vintage and prepayment protection:

	As of June 30, 2012				
(dollars in thousands)	Fixed Rate	Hybrid ARMs	Total Agency RMBS		
Lower loan balances	$3,641,377	$—	$3,641,377	42	%
High LTV	1,790,171	—	1,790,171	21	%
Home equity conversion mortgages	1,504,930	—	1,504,930	17	%
Seasoned (2005 and prior vintages)	494,800	138,330	633,130	7	%
Pre-pay lock-out or penalty-based	480,554	35,150	515,704	6	%
Low FICO	325,060	—	325,060	4	%
2006 and subsequent vintages	250,381	48,088	298,469	3	%
2006 and subsequent vintages - discount	3,361	—	3,361	—	%

Total	$8,490,634	$221,568	$8,712,202	100	%

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	As of December 31, 2011			
(dollars in thousands)	Fixed Rate	Hybrid ARMs	Total Agency RMBS	
Lower loan balances	$2,759,091	$—	$2,759,091	55 %
High LTV	211,312	—	211,312	4 %
Home equity conversion mortgages	939,738	—	939,738	19 %
Seasoned (2005 and prior vintages)	346,624	146,826	493,450	10 %
Pre-pay lock-out or penalty-based	266,456	34,826	301,282	6 %
2006 and subsequent vintages	123,323	50,026	173,349	3 %
2006 and subsequent vintages - discount	174,935	—	174,935	3 %
Total	$4,821,479	$231,678	$5,053,157	100 %

We offset a portion of the Agency exposure to prepayment speeds through our non-Agency portfolio. Our non-Agency RMBS yields are expected to increase if prepayment rates on such assets exceed our prepayment assumptions. To the extent that prepayment speeds increase due to macroeconomic factors, we expect to benefit from the ability to recognize the income from the heavily discounted RMBS prices that principally arose from credit or payment default expectations.
The following tables provide discount information on our non-Agency RMBS portfolio:

	As of June 30, 2012			
(in thousands)	Principal and Interest Securities		Interest-Only Securities	Total
	Senior	Mezzanine		
Face Value	$3,451,341	$771,285	$69,302	$4,291,928
Unamortized discount				
Designated credit reserve	(1,194,656)	(127,442)	—	(1,322,098)
Unamortized net discount	(653,295)	(225,498)	(65,505)	(944,298)
Amortized Cost	$1,603,390	$418,345	$3,797	$2,025,532

	As of December 31, 2011			
(in thousands)	Principal and Interest Securities		Interest-Only Securities	Total
	Senior	Mezzanine		
Face Value	$2,104,161	$551,867	$11,901	$2,667,929
Unamortized discount				
Designated credit reserve	(663,890)	(118,716)	—	(782,606)
Unamortized net discount	(387,759)	(141,715)	(11,495)	(540,969)
Amortized Cost	$1,052,512	$291,436	$406	$1,344,354

Credit losses
Although our Agency portfolio is supported by U.S. Government agency and federally chartered corporation guarantees of payment of principal and interest, we are exposed to credit risk in our non-Agency RMBS portfolio. However, the credit support built into non-Agency RMBS deal structures is designed to provide a level of protection from potential credit losses for more senior tranches. In addition, the discounted purchase prices paid on our non-Agency RMBS assets provide additional insulation from credit losses in the event we receive less than 100% of par on such assets. We evaluate credit risk on our non-Agency investments through a comprehensive asset selection process, which is predominantly focused on quantifying and pricing credit risk. We review our non-Agency RMBS based on a quantitative and qualitative analysis of the risk-adjusted returns on such investments. We evaluate each investment's credit risk through our initial modeling and scenario analysis and through on-going asset surveillance. At purchase, we estimate the portion of the discount we do not expect to recover and factor that into our expected yield and accretion methodology. We may also record an other-than-temporary impairment, or OTTI, for a portion of our investment in a security to the extent we believe that the amortized cost exceeds the present value of expected future

cash flows. Nevertheless, unanticipated credit losses could occur, adversely impacting our operating results.

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Counterparty exposure and leverage ratio

We monitor counterparty exposure in our broker, banking and lending counterparties on a daily basis. We believe our broker and banking counterparties are well capitalized organizations and we attempt to manage our cash balances across these organizations to reduce our exposure to a single counterparty.

We had entered into repurchase agreements with 23 counterparties as of June 30, 2012. As of June 30, 2012, we had a total consolidated debt to equity ratio of 4.8 times. As of June 30, 2012, we had $496.7 million in cash and cash equivalents, approximately $22.8 million of unpledged Agency securities and derivatives and $58.8 million of unpledged non-Agency securities and an overall estimated unused borrowing capacity on our unpledged RMBS of approximately $55.7 million. If borrowing rates and collateral requirements change in the near term, we believe we are subject to less earnings volatility than a more levered organization.

Summary of Results of Operations and Financial Condition

Our reported GAAP net income attributable to common stockholders was $24.0 million ($0.11 per diluted weighted share) for the three months ended June 30, 2012 as compared to a GAAP net loss attributable to common stockholders of $1.0 million ($0.01 per diluted weighted share) for the three months ended June 30, 2011. Our reported GAAP net income attributable to common stockholders was $75.8 million ($0.38 per diluted weighted share) for the six months ended June 30, 2012 as compared to a GAAP net income attributable to common stockholders of $21.4 million ($0.35 per diluted weighted share) for the six months ended June 30, 2011.

On June 12, 2012, we declared a dividend of $0.40 per diluted share. Our GAAP book value per diluted common share was $9.94 at June 30, 2012, an increase from $9.03 book value per diluted common share at December 31, 2011.

The following table presents the components of our net income (loss) for the three and six months ended June 30, 2012 and 2011: