UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended September 30, 2014

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from to

Commission File Number: 001-35543

Western Asset Mortgage Capital Corporation

(Exact name of Registrant as specified in its charter)

Delaware	**27-0298092**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

Western Asset Mortgage Capital Corporation

385 East Colorado Boulevard

Pasadena, California 91101

(Address of Registrant s principal executive offices)

(626) 844-9400

(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 a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (check one).

Large accelerated filer o	Accelerated filer x	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 under the Securities Exchange Act of 1934). Yes o No x

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

As of November 6, 2014, there were 41,718,467 shares, par value $0.01, of the registrant s common stock issued and outstanding.

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Western Asset Mortgage Capital Corporation and Subsidiaries

Consolidated Balance Sheets (Unaudited)

(in thousands except share and per share data)

	September 30, 2014	December 31, 2013
Assets:		
Cash and cash equivalents	$ 56,067	$ 48,525
Mortgage-backed securities and other securities, at fair value ($4,345,855 and $2,818,947 pledged as collateral, at fair value, respectively)	4,389,891	2,853,587
Linked transactions, net, at fair value	13,917	18,559
Investment related receivable	24	341
Accrued interest receivable	35,631	12,266
Due from counterparties	149,666	55,434
Derivative assets, at fair value	42,220	105,826
Other assets	618	339
Total Assets	$ 4,688,034	$ 3,094,877
Liabilities and Stockholders Equity:		
Liabilities:		
Borrowings under repurchase agreements	$ 3,882,127	$ 2,579,067
Accrued interest payable	24,570	12,534
Investment related payable	14,832	
Due to counterparties	3,307	65,861
Derivative liability, at fair value	92,218	4,673
Accounts payable and accrued expenses	2,299	1,353
Underwriting and offering costs payable		8
Payable to related party	3,056	1,842
Dividend payable	29,203	19,445
Total Liabilities	4,051,612	2,684,783
Commitments and contingencies		
Stockholders Equity:		
Common stock, $0.01 par value, 500,000,000 shares authorized, 41,718,467 and 26,853,287 shares issued and outstanding, respectively	417	268
Preferred stock, $0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	760,365	544,143
Retained earnings (accumulated deficit)	(124,360)	(134,317)
Total Stockholders Equity	636,422	410,094
Total Liabilities and Stockholders Equity	$ 4,688,034	$ 3,094,877

See notes to unaudited consolidated financial statements.

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Western Asset Mortgage Capital Corporation and Subsidiaries

Consolidated Statement of Operations (Unaudited)

(in thousands except share and per share data)

	For the three months ended September 30, 2014	For the three months ended September 30, 2013	For the nine months ended September 30, 2014	For the nine months ended September 30, 2013
Net Interest Income:				
Interest income	$ 40,718	$ 30,654	$ 108,752	$ 97,146
Interest expense	6,468	4,273	15,829	13,976
Net Interest Income	34,250	26,381	92,923	83,170
Other Income (Loss):				
Interest income on cash balances and other income (loss), net	942	11	954	56
Realized gain (loss) on sale of Mortgage-backed securities and other securities, net	4,912	(46,142)	(2,650)	(63,885)
Other loss on Mortgage-backed securities and other securities	(2,857)	(2,363)	(7,565)	(8,164)
Unrealized gain (loss) on Mortgage-backed securities and other securities, net	(4,453)	37,528	140,755	(173,517)
Gain (loss) on linked transactions, net	(1,241)	(547)	1,666	3,958
Gain (loss) on derivative instruments, net	(401)	(3,809)	(126,984)	120,505
Other Income (Loss), net	(3,098)	(15,322)	6,176	(121,047)
Operating Expenses:				
General and administrative (includes $587, $287, $1,654 and $824 non-cash stock based compensation, respectively)	2,253	1,484	6,703	4,762
Management fee related party	2,763	2,032	7,127	5,971
Total Operating Expenses	5,016	3,516	13,830	10,733
Net income (loss) available to Common Stock and participating securities	$ 26,136	$ 7,543	$ 85,269	$ (48,610)
Net income (loss) per Common Share Basic	$ 0.63	$ 0.31	$ 2.35	$ (2.04)
Net income (loss) per Common Share Diluted	$ 0.63	$ 0.31	$ 2.35	$ (2.04)
Dividends Declared per Share of Common Stock	$ 0.70	$ 0.90	$ 2.04	$ 2.75

See notes to unaudited consolidated financial statements.

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Western Asset Mortgage Capital Corporation and Subsidiaries

Consolidated Statement of Changes in Stockholders Equity (Unaudited)

(in thousands except shares and share data)

	Common Stock		Additional Paid-In Capital	Retained Earnings (Accumulated) Deficit	Total
	Shares	**Par**			
Balance at December 31, 2013	26,853,287	$ 268	$ 544,143	$ (134,317)	$ 410,094
Proceeds from public offering of common stock, net	14,000,000	140	205,240		205,380
Offering costs, public offerings of common stock			(400)		(400)
Proceeds from private placement of common stock	650,000	7	9,646		9,653
Grants of restricted stock	215,180	2	(2)		
Vesting of restricted stock			1,716		1,716
Net income				85,269	85,269
Dividends declared on common stock			22	(75,312)	(75,290)
Balance at September 30, 2014	41,718,467	$ 417	$ 760,365	$ (124,360)	$ 636,422

See notes to unaudited consolidated financial statements.

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Western Asset Mortgage Capital Corporation and Subsidiaries

Consolidated Statement of Cash Flows (Unaudited)

(in thousands)

	For the nine months ended September 30, 2014	For the nine months ended September 30, 2013
Cash flows from operating activities:		
Net income (loss)	$ 85,269	$ (48,610)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Premium amortization and (discount accretion), net	8,049	19,061
Restricted stock amortization expense	1,654	824
Unrealized (gain) loss on Mortgage-backed securities and other securities, net	(140,755)	173,517
Mark-to-market adjustments on linked transactions	1,339	(846)
Mark-to-market adjustments on derivative instruments	147,968	(42,884)
Other loss on Mortgage-backed securities and other securities	7,565	8,164
Realized loss on sale of Mortgage-backed securities and other securities, net	2,650	63,885
Realized loss on sale of Interest-Only Strips accounted for as derivatives, net	755	99
Realized (gain) loss on sale of TBAs, net	(25,169)	1,547
Realized (gain) loss on sale of swaptions, net	5,908	(23,671)
Realized loss on futures	16,495	
Realized loss on forward contracts	1,182	
Realized loss on expiration of option derivatives, net		925
Realized gain on linked transaction, net	(1,397)	(3,049)
Realized gain on foreign currency transactions	(1,119)	
Changes in operating assets and liabilities:		
(Increase) decrease in accrued interest receivable	(23,365)	3,972
Increase in other assets	(279)	(290)
Increase in accrued interest payable	12,036	560
Increase in accounts payable and accrued expenses	1,008	441
Increase in payable to related party	1,214	108
Net cash provided by operating activities	101,008	153,753
Cash flows from investing activities:		
Purchase of Mortgage-backed securities and other securities	(3,804,044)	(1,833,371)
Purchase of securities underlying linked transactions	(38,224)	(96,023)
Proceeds from sale of Mortgage-backed securities and other securities	2,240,338	2,748,309
Proceeds from sale of securities underlying linked transactions	6,214	21,735
Principal payments and basis recovered on Mortgage-backed securities and other securities	233,796	236,226
Principal payments and basis recovered on securities underlying linked transactions	4,408	1,138
Payment of premium for option derivatives	(2,813)	(4,675)
Premium received from option derivatives		3,750
Proceeds from gross settlement of TBAs		208,313
Net settlements of TBAs	25,169	(1,043)
Payment on termination of futures	(16,495)	
Proceeds from sale of interest rate swaptions		60,482
Premium for interest rate swaps, net	(2,235)	
Premium for interest rate swaptions, net	1,615	(23,544)
Net cash provided by (used in) investing activities	(1,352,271)	1,321,297

Cash flows from financing activities:				
Proceeds from issuance of common stock		205,380		
Proceeds from private placement of common stock (concurrent with initial public offering)		9,653		
Payment of offering costs		(409)		(67)
Proceeds from repurchase agreement borrowings		18,164,190		25,528,226
Proceeds from repurchase agreement borrowings underlying linked transactions		142,530		103,902
Repayments of repurchase agreement borrowings		(16,861,130)		(27,014,086)
Repayments of repurchase agreement borrowings underlying linked transactions		(178,948)		(103,902)
Repayment of cash overdraft				(5,666)
Proceeds from forward contracts		14,022		
Repayments of forward contracts		(15,205)		
Premium for interest rate swaps		1,040		
Due from counterparties		(94,232)		10,026
Due to counterparties		(62,554)		61,598
Dividends on common stock		(65,532)		(72,004)
Net cash provided by (used in) financing activities		1,258,805		(1,491,973)
Net increase (decrease) in cash and cash equivalents		7,542		(16,923)
Cash and cash equivalents beginning of period		48,525		56,292
Cash and cash equivalents end of period	$	56,067	$	39,369
Supplemental disclosure of operating cash flow information:				
Interest paid	$	14,350	$	15,607
Supplemental disclosure of non-cash financing/investing activities:				
Principal payments of mortgage-backed securities, not settled	$	(317)	$	
Mortgage-backed securities and other securities sold, not settled	$		$	147,540
Mortgage-backed securities and other securities purchased, not settled	$	(14,832)	$	(48,512)
Mortgage-backed securities recorded upon unlinking of linked transactions	$	(69,838)	$	(77,046)
Mortgage-backed securities used to settle TBAs	$		$	208,817
Deferred offering costs payable	$	(8)	$	
Dividends and distributions declared, not paid	$	29,203	$	21,883

See notes to unaudited consolidated financial statements.

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Western Asset Mortgage Capital Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

(in thousands-except share and per share data)

The following defines certain of the commonly used terms in these Notes to Consolidated Financial Statements: Agency or Agencies refer to a federally chartered corporation, such as the Federal National Mortgage Association (Fannie Mae or FNMA) or the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), or an agency of the U.S. Government, such as the Government National Mortgage Association (Ginnie Mae or GNMA); references to MBS refer to mortgage backed securities, including residential mortgage-backed securities or RMBS , commercial mortgage-backed securities or CMBS , and Interest-Only Strips (as defined herein); Agency MBS refer to RMBS, CMBS and Interest-Only Strips issued or guaranteed by the Agencies while Non-Agency MBS refer to RMBS, CMBS and Interest-Only Strips that are not issued or guaranteed by the Agencies; references to ARMs refers to adjustable rate mortgages; references to Interest-Only Strips refer to interest-only (IO) and inverse interest-only (IIO) securities issued as part of or collateralized with MBS.

Note 1 Organization

Western Asset Mortgage Capital Corporation and Subsidiaries (is referred to throughout this report as the Company) is a real estate finance company. At the Company s launch in May 2012, its initial investment strategy focused primarily on Agency RMBS (including TBAs as defined herein). Over time, the Company has expanded its investment strategy to include both Non-Agency RMBS and subsequently, Agency and Non-Agency CMBS. In addition, and to a significantly lesser extent, the Company has invested in other securities including certain Agency obligations that are not technically MBS and in asset backed securities (ABS). The Company s Manager, as defined below, is also actively pursuing investing in whole loans or whole loan securities as set forth in more detail herein and subsequent to September 30, 2014, completed its first purchase of these instruments. These changes in the Company s investment strategy, including future changes, are based on the Manager s perspective of which mix of portfolio assets it believes provide the Company with the best risk-reward opportunities at any given time.

The Company is externally managed by Western Asset Management Company (WAM , or the Manager), an investment advisor registered with the Securities and Exchange Commission (SEC). WAM is a wholly-owned subsidiary of Legg Mason, Inc. The Company operates and has elected to be taxed as a real estate investment trust or REIT commencing with its taxable year ended December 31, 2012.

In light of the aforementioned developments and given the Manager s current market outlook and investment view, while it can be expected that Agency RMBS will continue to be a significant part of the Company s portfolio, Agency RMBS will not necessarily be our primary investment in the future. Going forward, the Manager may vary the allocation among various asset classes subject to maintaining the Company s qualification as a REIT under federal tax law and maintaining its exemption from the Investment Company Act of 1940 (the 1940 Act). These restrictions limit the Company s ability to invest in non-real estate assets and/or assets which are not secured by real estate. Accordingly, the Company s portfolio will continue to be principally invested in MBS and other real estate related assets.

Note 2 Summary of Significant Accounting Policies

Basis of Presentation and Consolidation

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to present fairly the Company s financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. These consolidated financial statements should be read in conjunction with the Company s annual report on Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission (SEC) on March 17, 2014. The results of operations for the period ended September 30, 2014 are not necessarily indicative of the results to be expected for the full year or any future period.

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The interim unaudited consolidated financial statements include the Company s accounts and those of its consolidated subsidiary. All intercompany amounts have been eliminated in consolidation.

The Company currently operates as one business segment.

Cash and Cash Equivalents

The Company considers all highly-liquid short term investments with original maturities of 90 days or less when purchased to be cash equivalents. Cash and cash equivalents are exposed to concentrations of credit risk. The Company places its cash and cash equivalents with what it believes to be high credit quality institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit.

Classification of mortgage-backed securities and other securities and valuations of financial instruments

Mortgage-backed and other securities - Fair value election

The Company has elected the fair value option for all of its MBS and other securities at the date of purchase, which permits the Company to measure these securities at fair value with the change in fair value included as a component of earnings. In the Manager s view, this election more appropriately reflects the results of the Company s operations for a particular reporting period, as financial asset fair value changes are presented in a manner consistent with the presentation and timing of the fair value changes of economic hedging instruments.

Balance Sheet Presentation

The Company s mortgage-backed securities and other securities purchases and sales are recorded on the trade date, which results in an investment related payable (receivable) for MBS and other securities purchased (sold) for which settlement has not taken place as of the balance sheet date. The Company s MBS and other securities are pledged as collateral against borrowings under repurchase agreements. Other than MBS and other securities which are accounted for as linked transactions, described below, the Company s MBS and other securities are included in Mortgage-backed securities and other securities at fair value and Investment related receivables on the Consolidated Balance Sheets, with the fair value of such MBS and other securities pledged disclosed parenthetically.

Valuation of financial instruments

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable, for example, when there is little or no market activity for an investment at the end of the period, unobservable inputs may be used.

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The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Transfers between levels are determined by the Company at the end of the reporting period.

When available, the Company uses quoted market prices to determine the fair value of an asset or liability. If quoted market prices are not available, the Company consults with independent pricing services or obtains third party broker quotes. If independent pricing service, or third party broker quotes are not available, the Company determines the fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates and when applicable, estimates of prepayment and credit losses.

Valuation techniques for MBS and other securities may be based upon models that consider the estimated cash flows of the security. When applicable, the primary inputs to the model include yields for Agency To-Be-Announced securities (also known as   TBAs), Agency MBS, the U.S. Treasury market and floating rate indices such as the London interbank offered rate or LIBOR, the Constant Maturity Treasury rate and the prime rate as a benchmark yield. In addition, the model may incorporate the current weighted average maturity and additional pool level information such as prepayment speeds, default frequencies and default severities, if applicable. To the extent such inputs are observable and timely, these securities are categorized as Level II of the fair value hierarchy; otherwise, unless alternative pricing information as described above is available, they are categorized as Level III.

While linked transactions, described below, are treated as derivatives for GAAP, the securities underlying the Company s linked transactions are valued using similar techniques to those used for the Company s securities portfolio. The value of the underlying security is then netted against the carrying amount (which approximates fair value) of the repurchase agreement at the valuation date. Additionally, TBA instruments are similar in substance to the Company s Agency RMBS portfolio, and the Company therefore estimates fair value based on similar methods.

The Company determines the fair value of derivative financial instruments by obtaining quotes from third party pricing services, whose pricing is subject to review by the Manager s pricing committee. In valuing its over-the-counter interest rate derivatives, such as swaps and swaptions, and its currency derivatives, such as swaps and forwards, the Company considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement, from the perspective of both the Company and its counterparties. All of the Company s interest rate swaps are either cleared through a central clearing house and subject to the clearing house margin requirements or subject to bilateral collateral arrangements. The Company s agreements with its derivative counterparties also contain netting provisions; however the Company has elected to report its interest rate swaps and currency swaps on a gross basis. No credit valuation adjustment was made in determining the fair value of interest rate and/or currency derivatives.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If the Company is forced to sell assets in a short period to meet liquidity needs, the prices it receives can be substantially less than their recorded fair values. Furthermore, the analysis of whether it is more likely than not that the Company will not be required to sell securities in an unrealized loss position before recovery of its amortized cost basis, the amount of such expected required sales, and the projected identification of which securities will be sold is also subject to significant judgment, particularly in times of market illiquidity.

Any changes to the valuation methodology will be reviewed by the Company and its Manager to ensure the changes are appropriate. As markets and products develop and the pricing for certain products becomes more transparent, the Company will continue to refine its valuation methodologies. The Company utilizes and follows the pricing methodology and fair value hierarchy employed by its Manager, including its review and challenge process. The methods used by the Company may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company anticipates that its valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments can result in a different estimate of fair value at the reporting date. The Company uses inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

All valuations received from independent pricing services are non-binding. The Company primarily utilizes an independent third party pricing service as the primary source for valuing the Company s assets.

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The Company generally receives one independent pricing service price for each investment in the Company s portfolio. The Manager has established a process to review and validate the pricing received from the independent pricing service and has a process for challenging prices received from the independent pricing service when necessary. The Company utilizes our Manager s policies in this regard. The Company s and the Manager s review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. The Manager s pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager s pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, our Manager generally challenges the independent pricing service price.

To ensure proper fair value hierarchy, The Company and the Manager review the methodology and data used by the third party pricing service to understand whether observable market data is being utilized in the vendor s pricing methodology. Generally, this review is conducted annually, however ad-hoc reviews of the pricing methodology and the data does occur. The review of the assumptive data received from the vendor includes comparing key inputs. In addition, as part of the Company s regular review of pricing, the Manager s pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination as well as performing back testing with regard to the sale of certain securities. The conclusion that a price should be overridden in accordance with the Manager s pricing methodology may impact the fair value hierarchy of the security for which such price has been adjusted.

Interest income recognition and Impairment

Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase

Interest income on mortgage-backed and other securities is accrued based on the respective outstanding principal balances and corresponding contractual terms. Premiums and discounts associated with Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. The Company estimates prepayments at least quarterly for its securities and as a result, if prepayments increase (or are expected to increase), the Company will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) the Company will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

A change in the calculation used to determine the amortization of bond premium as of April 1, 2014, resulted in a change in estimate of approximately $1.2 million. The impact of the change in estimate was limited to an increase of approximately $1.2 million to Interest Income and an offsetting reduction to Unrealized gain (loss) on Mortgage-backed securities and other securities, net on the Consolidated Statement of Operations. The Company does not believe the aforementioned change in estimate will have a material impact to subsequent periods.

The Company assesses its Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company s intent not to sell the security and whether it is more likely than not that Company will not be required to sell the security until recovery of its amortized cost basis. An other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company s Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as the Company s estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives

Interest income on Non-Agency MBS and other securities that are rated below AA at the time of purchase and Interest-Only Strips that are not classified as derivatives are recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which is estimated based on the Company s observation of the then current information and events, where applicable, and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, the Company reviews and, if appropriate, makes adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses (if applicable), and other factors. The Company may include in its cash flow projections the U.S Department of Justice s settlements with the major residential mortgage originators, regarding certain lending practices. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities are affected by the contractual lives of the underlying collateral, periodic payments of scheduled principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of such securities purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company s Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities.

Securities denominated in a foreign currency contain additional risk in that the amortized cost basis for those securities may not be recovered due to declines in currency exchange rates. The Company considers the length of time that the security s fair value has declined due to the decline in foreign exchange rates, when assessing other-than temporary impairment.

The determination as to whether an other-than-temporary impairment exists is subject to management estimates based on consideration of both factual information available at the time of assessment as well as the Company s estimates of the future performance and projected amount and timing of cash flows expected to be collected on the security. As a result, the timing and amount of an other-than-temporary impairment constitutes an accounting estimate that may change materially over time.

Finally, certain of the Company s MBS and other securities that are in an unrealized loss position at September 30, 2014 are also not considered other-than-temporarily impaired because the Company has no intent to sell these investments, it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis and the Company is not required to sell the security for regulatory or other reasons.

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Sales of securities

Sales of securities are driven by the Company s portfolio management process. The Company seeks to mitigate risks including those associated with prepayments and will opportunistically rotate the portfolio into securities and/or other assets the Company s Manager believes have more favorable attributes. Strategies may also be employed to manage net capital gains, which need to be distributed for tax purposes. Realized gains or losses on sales of securities, including Agency Interest-Only Strips not characterized as derivatives, are included in the net Realized gain (loss) on sale of Mortgage-backed securities and other securities, net line item on the Consolidated Statement of Operations, and are recorded at the time of disposition. Realized gains or losses on sales of securities which are part of a linked transaction are included in Gain (loss) on linked transactions, net while realized gains losses on Interest-Only Strips which are characterized as derivatives are included in Gain (loss) on derivative instruments, net line item in the Consolidated Statement of Operations. The cost of positions sold is calculated using the specific identification method.

Securities in an unrealized loss position at the end of each reporting period are evaluated by the Company s Manager to determine whether the Company has the intent to sell such securities. To the extent the Company has no intent as of the end of such reporting period to sell such investments and it is more likely than not that the Company will not be required to sell the investment before recovery of its amortized cost basis, such unrealized loss is included in Unrealized gain (loss) on Mortgage-backed securities and other securities, net in the Consolidated Statement of Operations. Otherwise, when the Company has determined its intent to sell such securities, the unrealized loss is characterized as a realized loss and included in Other loss on Mortgage-backed securities and other securities on the Consolidated Statement of Operations. The Company has no intent to sell any of its investments in an unrealized loss position at September 30, 2014.

Foreign currency transactions

The Company expects to enter into transactions denominated in foreign currency from time to time. At the date the transaction is recognized, the asset and/or liability will be measured and recorded using the exchange rate in effect at the date of the transaction. At each balance sheet date, such foreign currency assets and liabilities are re-measured using the exchange rate in effect at the date of the balance sheet, resulting in unrealized foreign currency gains or losses. Unrealized foreign currency gains or losses on MBS and other securities are recorded in Unrealized gain (loss) on Mortgage-backed securities and other securities, net on the Consolidated Statement of Operations. Unrealized and realized foreign currency gains or losses on borrowings under repurchase agreements are recorded in Interest income on cash balances and other income (loss), net on the Consolidated Statement of Operations. Interest income from investments denominated in a foreign currency and interest expense on borrowings denominated in a foreign currency are recorded at the average rate of exchange during the period.

Due from counterparties/Due to counterparties

Due from counterparties represents cash posted by the Company with its counterparties as collateral for the Company s interest rate and/or currency derivative financial instruments, repurchase agreements and TBAs. Due to counterparties represents cash posted with the Company by its counterparties as collateral under the Company s interest rate and/or currency derivative financial instruments and repurchase agreements. To the extent the Company receives collateral other than cash from its counterparties such assets are not included in the Company s Consolidated Balance Sheets. Notwithstanding the foregoing, if the Company either rehypothecates such assets or pledges the assets as collateral pursuant to a repurchase agreement, the cash received and the corresponding liability is reflected on the Consolidated Balance Sheets.

Derivatives and hedging activities

Subject to maintaining its qualification as a REIT for U.S. federal income tax purposes, the Company utilizes derivative financial instruments, including interest rate swaps, interest rate swaptions, mortgage put options, currency swaps and forwards, futures contracts, TBAs and Agency and Non-Agency Interest-Only Strips to hedge the interest rate and currency risk associated with its portfolio and related borrowings. Derivatives are used for hedging purposes rather than speculation, including overall market risk. The Company determines the fair value of its derivative positions and obtains quotations from third parties, including the Chicago Mercantile Exchange or CME, to facilitate the process of determining such fair values. If the Company s hedging activities do not achieve the desired results, reported earnings may be adversely affected.

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GAAP requires an entity to recognize all derivatives as either assets or liabilities and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives are classified as either hedges of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge) or hedges of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). Fair value adjustments are recorded in earnings immediately, if the Company does not elect hedge accounting for a derivative instrument.

The Company elected not to apply hedge accounting for its derivative instruments and records the change in fair value, net interest rate swap payments (including accrued amounts) and net currency payments (including accrued amounts) related to interest rate swaps and currency swaps, respectively in Gain (loss) on derivative instruments, net in its Consolidated Statement of Operations.

The Company also invests in Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs. The Company evaluates the terms and conditions of its holdings of Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs to determine if these instruments have the characteristics of an investment or should be considered a derivative under GAAP. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value. Accordingly, Agency and Non-Agency Interest-Only Strips, interest rate swaptions, currency forwards, futures contracts and TBAs having the characteristics of derivatives are accounted for at fair value with such changes recognized in Gain (loss) on derivative instruments, net in its Consolidated Statement of Operations, along with any interest earned (including accrued amounts). The carrying value of the Agency and Non-Agency Interest-Only Strips, accounted for as derivatives, is included in Mortgage-backed securities on the Consolidated Balance Sheets. The carrying value of interest rate swaptions, currency forwards, futures contracts and TBAs is included in Derivative assets or Derivative liabilities on the Consolidated Balance Sheets.

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. An embedded derivative is separated from the host contact and accounted for separately when all of the guidance criteria are met. Hybrid instruments that are remeasured at fair value through earnings, including the fair value option are not bifurcated. Derivative instruments, including derivative instruments accounted for as liabilities, are recorded at fair value and are re-valued at each reporting date, with changes in the fair value together with interest earned (including accrued amounts) reported in the Gain (loss) on derivatives, net in the Statements of Operations. See Warrants below.

Repurchase agreements

Mortgage-backed securities and other securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on the Company s Consolidated Balance Sheets as assets and cash received from the lender is recorded in the Company s Consolidated Balance Sheets as a liability, unless such transaction is accounted for as a linked transaction, described below. Interest paid in accordance with repurchase agreements is recorded as interest expense, unless the repurchase agreement is accounted for as a linked transaction, described below. The Company reflects all proceeds from repurchase agreement borrowings and repayment of repurchase agreement borrowings which are not linked transactions, including transactions pertaining to collateral received with respect to certain swap transactions, on a gross basis on the Consolidated Statement of Cash Flows.

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Linked transactions

In instances where the Company acquires a security through a repurchase agreement with the same counterparty from which the security was purchased, the Company evaluates such transaction in accordance with GAAP. This guidance requires that if the initial transfer of a financial asset and repurchase financing are entered into contemporaneously with, or in contemplation of, one another such transaction shall be considered linked unless all of the criteria found in the guidance are met at the inception of the transaction. If the transaction meets all of the conditions, the initial transfer shall be accounted for separately from the repurchase financing, and the Company will record the security and the related financing on a gross basis on its Consolidated Balance Sheets with the corresponding interest income and interest expense in the Consolidated Statements of Operations. If the transaction is determined to be linked, the Company will record the initial transfer and repurchase financing on a net basis and record a forward commitment to purchase the security as a derivative instrument with changes in market value being recorded on the Consolidated Statement of Operations. Such forward commitment is recorded at fair value with subsequent changes in fair value recognized in Gain (loss) on linked transactions, net on its Consolidated Statement of Operations. The Company refers to these transactions as Linked Transactions. When or if a transaction is no longer considered to be linked, the security and related repurchase financing will be reported on a gross basis. The unlinking of a transaction causes a realized event in which the fair value of the security as of the date of unlinking will become the cost basis of the security. The difference between the fair value on the unlinking date and the existing cost basis of the security will be the realized gain or loss. Recognition of effective yield for such security will be calculated prospectively using the new cost basis. For linked transactions, the Company reflects purchases and sales of securities within the investing section of the Consolidated Statement of Cash Flows. Proceeds from repurchase agreements borrowings and repayments of repurchase agreement borrowings are reflected in the financing section of the Consolidated Statement of Cash Flows.

Share-based compensation

The Company accounts for share-based compensation to its independent directors, to any employee, to its Manager and to employees of its Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to the Company s independent directors including any such restricted stock which is subject to a deferred compensation program, and any employee of the Company is measured at its fair value at the grant date, and amortized into expense over the service period on a straight-line basis. Compensation cost related to restricted common stock issued to the Manager and to employees of the Manager, including officers of the Company who are employees of the Manager and its affiliates, is initially measured at fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis and re-measured on subsequent dates to the extent the awards are unvested.

Warrants

For the Company s warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company s common stock in the private placement to certain accredited institutional investors on May 15, 2012, were evaluated by the Company and were recorded at their relative fair value as a component of equity at the date of issuance. See Derivatives and hedging activities above.

Income taxes

The Company operates and has elected to be taxed as a REIT commencing with its taxable year ended December 31, 2012. Accordingly, the Company will generally not be subject to corporate U.S. federal or state income tax to the extent that the Company makes qualifying distributions to stockholders, and provided that the Company satisfies, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the failure to qualify as a REIT could have a material adverse impact on the Company s results of operations and amounts available for distribution to stockholders.

The dividends paid deduction for qualifying dividends paid to stockholders is computed using the Company s taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income reported on the consolidated financial statements because the determination of taxable income is based on tax provisions and not GAAP.

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The Company may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries (TRS). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes, and its value may not exceed 25% of the value of the Company. While a TRS may generate net income, a TRS can declare dividends to the Company, which will be included in the Company s taxable income and necessitate a distribution to its stockholders. Conversely, if the Company retains earnings at the TRS level, no distribution is required and it can increase book equity of the consolidated entity. As of September 30, 2014, the Company has a single wholly owned subsidiary which it has elected to treat as a TRS.

The Company evaluates uncertain tax positions, if any, and classifies interest and penalties, if any, related to unrecognized tax benefits, if any, as a component of the provision for income taxes.

Offering costs

Offering costs borne by the Company in connection with its IPO and concurrent private placements completed on May 15, 2012 as well as its follow-on public stock offering completed on October 3, 2012 and its follow-on public stock offering and concurrent private placement completed on April 9, 2014 (inclusive of the partial exercise of the greenshoe which was completed on May 7, 2014) are reflected as a reduction of additional paid-in-capital.

Earnings per share

GAAP requires use of the two-class method of computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity. The Company s participating securities are not allocated a share of the net loss as the participating securities do not have a contractual obligation to share in the net losses of the Company.

The remaining earnings are allocated to common stockholders and participating securities, to the extent that each security shares in earnings, as if all of the earnings for the period had been distributed. Each total is then divided by the applicable number of shares to arrive at basic earnings per share. For the diluted earnings, the denominator includes all outstanding common shares and all potential common shares assumed issued if they are dilutive. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of these potential common shares.

Comprehensive Income (Loss)

The Company has none of the components of comprehensive income (loss) and therefore comprehensive income (loss) is not presented.

Accounting standards applicable to emerging growth companies

The JOBS Act contains provisions that relax certain requirements for emerging growth companies , which includes the Company. For as long as the Company is an emerging growth company, which may be up to five full fiscal years, unlike other public companies, the Company will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor s attestation report on management s assessment of the effectiveness of the Company s system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012, unless the SEC determines otherwise.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. The Company intends to take advantage of such extended transition period. Since the Company will not be required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, its financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If the Company were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

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Recent accounting pronouncements

Accounting Standards to be Adopted in Future Periods

In June 2014, the Financial Accounting Standards Board issued guidance that changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. These transactions would all be accounted for as secured borrowings. The guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement, which has resulted in outcomes referred to as off-balance-sheet accounting. In addition, the guidance requires additional disclosures. The guidance is effective for the first interim or annual period beginning after December 15, 2014. Earlier application for a public company is prohibited. The Company currently accounts for certain transfers as forward agreements under the existing guidance, which are currently classified as linked transactions. The new guidance will require the Company to record these transfers as secured borrowings. The Company is currently assessing the impact that this accounting guidance will have on the Company s consolidated financial statements when adopted.

In August 2014, the Financial Accounting Standards Board issued guidance that will require an entity s management to evaluate whether there is substantial doubt about an entity s ability to continue as a going concern and to provide related footnote disclosures. According to the new guidance, substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued. The term probable is used consistently with its current use in U.S. GAAP for loss contingencies. Disclosures will be required if conditions give rise to substantial doubt about the entity s ability to continue as a going concern, including whether management s plans that are intended to mitigate those conditions will alleviate the substantial doubt when implemented. The guidance is effective for annual periods ending after December 15, 2016. Early application is permitted. The Company s first assessment under the new guidance will be completed for the year ending December 31, 2016.

Note 3 Fair Value of Financial Instruments

Fair Value Accounting Elections

The Company s MBS and other securities are designated as available-for-sale and the Company has elected the fair value option for all of its MBS and other securities, and as a result, all changes in the fair value of such securities are reflected in the results of operations.

Financial Instruments carried at Fair Value

The following tables present the Company s financial instruments carried at fair value as of September 30, 2014 and December 31, 2013, based upon the valuation hierarchy (dollars in thousands):

	September 30, 2014 Fair Value			
	Level I	Level II	Level III	Total
Assets				
Agency RMBS	$	$ 3,130,699	$	$ 3,130,699
Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS		82,460	4,716	87,176
Non-Agency RMBS		509,181	181,288	690,469
Agency and Non-Agency CMBS		305,733	71,577	377,310
Other securities		96,834	7,403	104,237
Subtotal		4,124,907	264,984	4,389,891
Derivative assets	104	39,643	2,473	42,220
Non-Agency RMBS linked transactions		1,719		1,719
Non-Agency CMBS linked transactions, including Non U.S.			9,348	9,348
Other securities linked transactions			2,850	2,850
Total	$ 104	$ 4,166,269	$ 279,655	$ 4,446,028
Liabilities				
Derivative liabilities	$ 414	$ 91,804	$	$ 92,218
Total	$ 414	$ 91,804	$	$ 92,218

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	December 31, 2013 Fair Value							
	Level I		Level II		Level III		Total	
Assets								
Agency RMBS	$		$	2,360,073	$		$	2,360,073
Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS				109,235				109,235
Non-Agency RMBS				325,371		6,152		331,523
Agency and Non-Agency CMBS				16,542		9,529		26,071
Other securities				26,685				26,685
Subtotal				2,837,906		15,681		2,853,587
Derivative assets				105,826				105,826
Non-Agency linked transactions				18,559				18,559
Total	$		$	2,962,291	$	15,681	$	2,977,972
Liabilities								
Derivative liabilities	$		$	4,673	$		$	4,673
Total	$		$	4,673	$		$	4,673

The following tables present additional information about the Company s financial instruments, which are measured at fair value on a recurring basis for which the Company has utilized Level III inputs to determine fair value:

	Mortgage-backed securities and other securities							
$ in thousands	Three months ended September 30, 2014		Three months ended September 30, 2013		Nine months ended September 30, 2014		Nine months ended September 30, 2013	
Beginning balance	$	130,584	$		$	15,681	$	
Transfers into Level III from Level II		95,845		7,013		133,136		7,013
Transfers out Level III into Level II		(11,207)				(27,910)		
Purchases		52,050		3,555		165,468		3,555
Sales and settlements		(3,204)				(26,646)		
Principal repayments		(72)				(91)		
Total net gains/(losses) included in net income								
Realized gains/(losses), net		(13)				2,848		
Other loss on Mortgage-backed securities								
Unrealized gains/(losses), net(1)		4,912		8		7,283		8
Premium and discount amortization, net		(3,911)		(4)		(4,785)		(4)
Ending balance	$	264,984	$	10,572	$	264,984	$	10,572

(1) For Mortgage-backed securities and other securities classified as Level III at September 30, 2014, the Company recorded gross unrealized gains of approximately $5.0 million and $6.3 million and gross unrealized losses of $112 thousand and $489 thousand for the three and nine months ended September 30, 2014, respectively. These gains and losses are included in Unrealized gain (loss) on Mortgage-backed securities and other securities, net on the Consolidated Statement of Operations.

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	Derivative Asset			
$ in thousands	Three months ended September 30, 2014	Three months ended September 30, 2013	Nine months ended September 30, 2014	Nine months ended September 30, 2013
Beginning balance	$	$	$	$
Transfers into Level III from Level II			126	
Transfers out Level III into Level II				
Purchases	2,813		2,813	
Sales and settlements				
Principal repayments				
Total net gains/(losses) included in net income				
Realized gains/(losses), net			(1,163)	
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net	(340)		697	
Premium and discount amortization, net				
Ending balance	$ 2,473	$	$ 2,473	$

	Linked transactions			
$ in thousands	Three months ended September 30, 2014	Three months ended September 30, 2013	Nine months ended September 30, 2014	Nine months ended September 30, 2013
Beginning balance	$	$	$	$
Transfers into Level III from Level II	9,348		9,348	
Transfers out Level III into Level II				
Purchases	2,840		2,840	
Sales and settlements				
Principal repayments				
Total net gains/(losses) included in net income				
Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net	(1)		(1)	
Premium and discount amortization, net	11		11	
Ending balance	$ 12,198	$	$ 12,198	$

	Derivative liabilities			
$ in thousands	Three months ended September 30, 2014	Three months ended September 30, 2013	Nine months ended September 30, 2014	Nine months ended September 30, 2013
Beginning balance	$ 863	$	$	$
Transfers into Level III from Level II				
Transfers out Level III into Level II				
Purchases				
Sales and settlements	(863)		(863)	
Principal repayments				
Total net gains/(losses) included in net income				

Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net			863	
Premium and discount amortization, net				
Ending balance	$	$	$	$

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Transfers between hierarchy levels during operations for the three and nine months ended September 30, 2014, were based on the availability of sufficient observable inputs to meet Level II versus Level III criteria. The valuation and leveling of these assets were based on information received from a third party pricing service which utilized significant unobservable inputs, along with the back-testing of historical sales transactions performed by the Manager.

The Company primarily utilizes an independent third party pricing service as the main source for valuing the Company s assets. All valuations received from independent pricing services are non-binding. The Company generally receives one independent pricing service price for each investment in its portfolio. The Manager has established a process to review and validate the pricing received from the independent pricing service and has a process for challenging prices received from the independent pricing service when necessary. The Company utilizes its Manager s policies in this regard. The Company s and the Manager s review of the independent third party pricing data may consist of a review of the daily change in the prices provided by the independent pricing vendor which exceed established tolerances or comparisons to executed transaction prices. The Manager s pricing group, which functions independently from its portfolio management personnel, corroborates the price differences or changes in price by comparing the vendor price to alternate sources including other independent pricing services or broker quotations. If the price change or difference cannot be corroborated, the Manager s pricing group consults with the portfolio management team for market color in reviewing such pricing data as warranted. To the extent that the Manager has information, typically in the form of broker quotations that would indicate that a price received from the independent pricing service is outside of a tolerance range, the Manager generally challenges the independent pricing service price. To ensure proper fair value hierarchy, the Company and the Manager review the methodology used by the third party pricing service to understand whether observable market data is being utilized in the vendor s pricing methodology. Generally, this review is conducted annually, however ad-hoc reviews of the pricing methodology and the data does occur. In addition, as part of the Company s regular review of pricing, the Manager s pricing group may have informal discussions with the independent pricing vendor regarding their evaluation methodology or the market data utilized in their determination as well as performing back testing with regard to the sale of certain securities.

Other Fair Value Disclosures

Due from counterparties and Due to counterparties on the Company s Consolidated Balance Sheets are reflected at cost which approximates fair value.

The fair value of the repurchase agreements is based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best estimate current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies could have a material effect on the fair value amounts. At September 30, 2014, the Company s borrowings under repurchase agreements had a fair value of approximately $3.9 billion and a carrying value of approximately $3.9 billion and would be considered a Level II fair value measurement.

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Note 4 Mortgage-Backed Securities and other securities

The following tables present certain information about the Company s investment portfolio at September 30, 2014 and December 31, 2013 (dollars in thousands). Real estate securities and other securities that are accounted for as a component of linked transactions are not reflected in the tables set forth in this note. See Note 7 for further details.

	September 30, 2014						
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year Mortgage	$ 1,082,403	$ 59,326	$	$ 1,141,729	$ (6,941)	$ 1,134,788	3.6%
30-Year Mortgage	1,695,477	133,215		1,828,692	(25,129)	1,803,563	4.1%
Agency RMBS Interest-Only Strips	N/A	N/A	N/A	185,335	7,013	192,348	4.0%(2)
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A	N/A	N/A	N/A	87,176	2.9%(2)
Non-Agency RMBS	790,238	6,822	(177,917)	619,143	10,317	629,460	3.7%
Non-Agency RMBS Interest-Only Strips	N/A	N/A	N/A	54,928	6,081	61,009	6.1%
Agency and Non-Agency CMBS	396,985	(20,673)	(7,354)	368,958	3,773	372,731	5.4%
Agency CMBS Interest-Only Strips	N/A	N/A	N/A	4,438	141	4,579	4.9%
Other securities (4)	91,570	4,326		103,307	930	104,237	4.9%
Total	$ 4,056,673	$ 183,016	$ (185,271)	$ 4,306,530	$ (3,815)	$ 4,389,891	4.0%

	December 31, 2013						
	Principal Balance	Unamortized Premium (Discount), net	Discount Designated as Credit Reserve and OTTI	Amortized Cost	Unrealized Gain (Loss), net	Estimated Fair Value	Net Weighted Average Coupon (1)
Agency RMBS:							
20-Year Mortgage	$ 504,023	$ 28,498	$	$ 532,521	$ (29,595)	$ 502,926	3.2%
30-Year Mortgage	1,677,863	144,356		1,822,219	(127,981)	1,694,238	3.8%
Agency RMBS Interest-Only Strips	N/A	N/A	N/A	158,825	4,084	162,909	4.4%(2)
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A	N/A	N/A	N/A	109,235	4.6%(2)
Non-Agency RMBS	446,473	(49,334)	(79,898)	317,241	6,792	324,033	2.3%
Non-Agency RMBS Interest-Only Strips	N/A	N/A	N/A	7,420	70	7,490	5.2%
Agency and Non-Agency CMBS	11,979	(3,446)		8,533	996	9,529	1.6%
CMBS Interest-Only Strips	N/A	N/A	N/A	16,682	(140)	16,542	4.7%(2)
Other securities	23,510	2,110	N/A	25,620	1,065	26,685	6.7%
Total	$ 2,663,848	$ 122,184	$ (79,898)	$ 2,889,061	$ (144,709)	$ 2,853,587	3.6%

(1) Net weighted average coupon as of September 30, 2014 and December 31, 2013 is presented, net of servicing and other fees.

(2) Agency and Non-Agency Interest-Only Strips, accounted for as derivatives and CMBS Interest-Only Strips have no principal balances and earn contractual interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.

(3) Interest on these securities is reported as a component of Gain (loss) on derivative instruments, net on the Consolidated Statement of Operations.

(4) Other securities include residual interests in asset-backed securities.

As of September 30, 2014 and December 31, 2013, the weighted average expected remaining term to the expected maturity of the investment portfolio, excluding linked transactions was 7.6 years and 8.5 years, respectively.

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The components of the carrying value of the Company s investment portfolio are as follows:

	September 30, 2014	December 31, 2013
Principal balance	$ 4,056,673	$ 2,663,848
Amortized cost of Interest-Only Strips and residual interests	252,112	182,927
Carrying value of Agency and Non-Agency Interest-Only Strips accounted for as derivatives	87,176	109,235
Unamortized premium	229,467	183,324
Unamortized discount	(46,451)	(61,140)
Discount designated as Credit Reserve and OTTI	(185,271)	(79,898)
Gross unrealized gains	51,423	19,798
Gross unrealized losses	(55,238)	(164,507)
Fair value	$ 4,389,891	$ 2,853,587

The following tables present the changes in the components of the Company s purchase discount and amortizable premium on its Non-Agency RMBS, Non-Agency CMBS and other securities for the three and nine months ended September 30, 2014 and 2013 (dollars in thousands):

	Three months ended September 30, 2014		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Amortizable Premium (1)
Balance at beginning of period	$ (206,374)	$ (107,368)	$ 103,261
Accretion of discount		3,845	
Amortization of premium			(2,461)
Realized credit losses	1,853		
Purchases	(31,080)	(10,173)	32,677
Sales	22,668	20,725	(20,700)
Net impairment losses recognized in earnings	(1,669)		
Unlinking of Linked Transactions			
Transfers/release of credit reserve	29,331	(1,923)	(27,408)
Balance at end of period	$ (185,271)	$ (94,894)	$ 85,369

(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

	Nine months ended September 30, 2014		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Amortizable Premium (1)
Balance at beginning of period	$ (79,898)	$ (71,295)	$ 20,625
Accretion of discount		11,389	
Amortization of premium			(6,129)
Realized credit losses	3,623		
Purchases	(162,805)	(105,261)	92,618
Sales	42,079	72,175	(25,718)

Net impairment losses recognized in earnings	(4,145)		
Unlinking of Linked Transactions	(13,889)	(297)	32,132
Transfers/release of credit reserve	29,764	(1,605)	(28,159)
Balance at end of period	$ (185,271)	$ (94,894)	$ 85,369

(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

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	Three months ended September 30, 2013		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Amortizable Premium (1)
Balance at beginning of period	$ (68,071)	$ (36,305)	$ 5,543
Accretion of discount		2,284	
Amortization of premium			198
Realized credit losses	144		
Purchases	(12,112)	(47,882)	14
Sales	4,846	20,893	(20)
Net impairment losses recognized in earnings	(319)		
Unlinking of Linked Transactions	(1,497)	(2,227)	
Transfers/release of credit reserve	2,426	(1,975)	(451)
Balance at end of period	$ (74,583)	$ (65,212)	$ 5,284

(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

	Nine months ended September 30, 2013		
	Discount Designated as Credit Reserve and OTTI	Accretable Discount (1)	Amortizable Premium (1)
Balance at beginning of period	$ (12,659)	$ (5,523)	$ 12
Accretion of discount		4,433	
Amortization of premium			858
Realized credit losses	386		
Purchases	(125,035)	(82,185)	22,374
Sales	78,959	30,327	(20,669)
Net impairment losses recognized in earnings	(319)		
Unlinking of Linked Transactions	(21,986)	(6,922)	3,438
Transfers/release of credit reserve	6,071	(5,342)	(729)
Balance at end of period	$ (74,583)	$ (65,212)	$ 5,284

(1) Together with coupon interest, accretable purchase discount and amortizable premium is recognized as interest income over the life of the security.

The following tables present the gross unrealized losses and estimated fair value of the Company s MBS and other securities by length of time that such securities have been in a continuous unrealized loss position at September 30, 2014 and December 31, 2013:

	September 30, 2014								
	Less than 12 Months			12 Months or More			Total		
	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities
Agency RMBS:									
20-Year Mortgage	$ 72,355	$ (309)	26	$ 440,972	$ (12,261)	55	$ 513,327	$ (12,570)	81

30-Year Mortgage	56,929	(154)	20	884,309	(36,618)	126	941,238	(36,772)	146
Agency RMBS Interest-Only Strips	52,548	(1,065)	13				52,548	(1,065)	13
Non-Agency RMBS	235,870	(2,551)	31				235,870	(2,551)	31
Agency and Non-Agency CMBS	167,399	(990)	27				167,399	(990)	27
Other securities	62,118	(1,290)	6				62,118	(1,290)	6
Total	$ 647,219	$ (6,359)	123	$ 1,325,281	$ (48,879)	181	$ 1,972,500	$ (55,238)	304

	December 31, 2013								
	Less than 12 Months			**12 Months or More**			**Total**		
	Fair Value	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**	**Number of Securities**
Agency RMBS:									
20-Year Mortgage	$ 395,979	$ (21,466)	52	$ 106,947	$ (8,129)	8	$ 502,926	$ (29,595)	60
30-Year Mortgage	1,242,871	(94,688)	151	439,811	(33,328)	26	1,682,682	(128,016)	177
Agency Interest-Only Strips	69,773	(4,210)	19				69,773	(4,210)	19
Non-Agency RMBS	98,437	(2,490)	16				98,437	(2,490)	16
Agency and Non-Agency CMBS	16,542	(140)	3				16,542	(140)	3
Other securities	6,269	(56)	2				6,269	(56)	2
Total	$ 1,829,871	$ (123,050)	243	$ 546,758	$ (41,457)	34	$ 2,376,629	$ (164,507)	277

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At September 30, 2014, the Company did not intend to sell any of its MBS and other securities that were in an unrealized loss position, and it is more likely than not that the Company will not be required to sell these MBS and other securities before recovery of their amortized cost basis, which may be at their maturity.

The Company assesses its Agency MBS, Non-Agency MBS and other securities, excluding Interest-Only Strips, rated AA and higher at the time of purchase for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary. In deciding on whether or not a security is other-than-temporarily impaired, the Company considers several factors, including the nature of the investment, communications (if any) from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company s intent not to sell the security and that it is more likely than not that the Company will not be required to sell the security until recovery of its amortized cost. In addition, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the security is less than its carrying amount. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. These adjustments are reflected in the Company s Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities.

For Non-Agency MBS and other securities rated below AA at the time of purchase and Agency and Non-Agency Interest-Only Strips, excluding Interest-Only Strips classified as derivatives, an other-than-temporary impairment is deemed to have occurred when there is an adverse change in the expected cash flows (principal or interest) to be received and the fair value of the beneficial interest is less than its carrying amount. Other than for plain-vanilla variable rate Non-Agency MBS, the Company does not bifurcate the loss between credit loss and loss attributed to change in interest rates, therefore, the entire loss is recorded as other-than-temporary. These adjustments are reflected in the Company s Consolidated Statement of Operations as Other loss on Mortgage-backed securities and other securities. In determining whether an adverse change in cash flows occurred, the present value of the remaining cash flows, as estimated at the initial transaction date (or the last date previously revised), is compared to the present value of the expected cash flows at the current reporting date. The estimated cash flows reflect those a market participant would use and are discounted at a rate equal to the current yield used to accrete interest income. If an other-than-temporary impairment is recognized as a result of this analysis, the yield is maintained at the current accretion rate. The last revised estimated cash flows are then used for future impairment analysis purposes. The Company s prepayment speed estimate is the primary assumption used to determine other-than temporary-impairments for Interest-Only Strips, excluding Agency and Non-Agency Interest-Only Strips accounted for as derivatives, for three and nine months ended September 30, 2014 and 2013.

The Company recorded other-than-temporary-impairments for the three and nine months ended September 30, 2014 of approximately $1.2 million and $3.4 million, respectively and approximately $2.0 million and $7.8 million for the three and nine months ended September 30, 2013, respectively, for Agency IOs, Agency IIOs and 20-year Agency RMBS. The Company recorded approximately $1.5 million and $3.9 million of other-than-temporary impairments for the three and nine months ended September 30, 2014, respectively, and $319 thousand for the three and nine months ended September 30, 2013, for Non-Agency MBS. The Company recorded approximately $104 thousand and $215 thousand of other-than-temporary-impairments for the three and nine months ended September 30, 2014, respectively, and $0 for the three and nine months ended September 30, 2013, for Non-Agency CMBS. In addition, the Company recorded approximately $30 thousand and $68 thousand of other-than-temporary-impairments for the three and nine months ended September 30, 2014, and $0 for the three and nine months ended September 30, 2013 for other securities. Other-than-temporary-impairments are reported as Other loss on Mortgage-backed securities and other securities in the Company s Consolidated Statement of Operations.

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The following tables present components of interest income on the Company s MBS and other securities (dollars in thousands).

	For the three months ended September 30, 2014		
	Coupon Interest	Net (Premium Amortization/ Amortization Basis) Discount Amortization	Interest Income
Agency RMBS	$ 40,245	$ (15,373)	$ 24,872
Non-Agency RMBS	11,177	(1,376)	9,801
Agency and Non-Agency CMBS	6,327	(1,407)	4,920
Other securities	1,033	92	1,125
Total	$ 58,782	$ (18,064)	$ 40,718

	For the nine months ended September 30, 2014		
	Coupon Interest	Net (Premium Amortization/ Amortization Basis) Discount Amortization	Interest Income
Agency RMBS	$ 114,703	$ (41,373)	$ 73,330
Non-Agency RMBS	24,579	(1,282)	23,297
Agency and Non-Agency CMBS	10,069	(940)	9,129
Other securities	2,663	333	2,996
Total	$ 152,014	$ (43,262)	$ 108,752

	For the three months ended September 30, 2013		
	Coupon Interest	Net (Premium Amortization/ Amortization Basis) Discount Amortization	Interest Income
Agency RMBS	$ 41,993	$ (14,777)	$ 27,216
Non-Agency RMBS	697	2,418	3,115
Agency and Non-Agency CMBS	8	14	22
Other securities	237	64	301
Total	$ 42,935	$ (12,281)	$ 30,654

	For the nine months ended September 30, 2013		
	Coupon Interest	Net (Premium Amortization/ Amortization Basis) Discount Amortization	Interest Income
Agency RMBS	$ 138,300	$ (48,506)	$ 89,794
Non-Agency RMBS	1,802	5,227	7,029
Agency and Non-Agency CMBS	8	14	22
Other securities	237	64	301
Total	$ 140,347	$ (43,201)	$ 97,146

The following tables present the sales of the Company s MBS and other securities (dollars in thousands):

	For the three months ended September 30, 2014							
		Proceeds		Gross Gains		Gross Losses		Net Gain (Loss)
Agency RMBS	$	268,694	$	2,557	$	(4,865)	$	(2,308)
Non-Agency RMBS		155,366		6,257		(414)		5,843
Agency and Non-Agency CMBS(1)		87,844		1,786		(20)		1,766
Other securities								
Total	$	511,904	$	10,600	$	(5,299)	$	5,301

(1) Includes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately $3.7 million, gross realized gains of $389 thousand and gross realized losses of $0.

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	For the nine months ended September 30, 2014			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	$ 1,605,046	$ 11,570	$ (40,934)	$ (29,364)
Non-Agency RMBS	395,456	19,759	(995)	18,764
Agency and Non-Agency CMBS(2)	160,904	2,153	(22)	2,131
Other securities	78,932	5,064		5,064
Total	$ 2,240,338	$ 38,546	$ (41,951)	$ (3,405)

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately $31.4 million, gross realized gains of $437 thousand and gross realized losses of approximately $1.6 million.

(2) Includes proceeds for Agency CMBS Interest-Only Strips, accounted for as derivatives, of approximately $3.7 million, gross realized gains of $389 thousand and gross realized losses of approximately $0.

	For the three months ended September 30, 2013			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS	$ 652,521	$	$ (47,036)	$ (47,036)
Non-Agency RMBS	22,753	571		571
Other securities	7,503	323		323
Total	$ 682,777	$ 894	$ (47,036)	$ (46,142)

	For the nine months ended September 30, 2013			
	Proceeds	Gross Gains	Gross Losses	Net Gain (Loss)
Agency RMBS (1)	$ 2,798,409	$ 8,646	$ (77,903)	$ (69,257)
Non-Agency RMBS	89,937	4,950		4,950
Other securities	7,503	323		323
Total	$ 2,895,849	$ 13,919	$ (77,903)	$ (63,984)

(1) Includes proceeds for Agency Interest-Only Strips, accounted for as derivatives, of approximately $8.4 million and gross realized losses of $99 thousand.

Note 5 Borrowings under Repurchase Agreements

As of September 30, 2014, the Company had master repurchase agreements with 23 counterparties. As of September 30, 2014, the Company had borrowings under repurchase agreements with 20 counterparties, excluding borrowings for linked transactions. The following tables summarize certain characteristics of the Company s repurchase agreements at September 30, 2014 and December 31, 2013 (dollars in thousands):

	September 30, 2014		
Securities Pledged	Repurchase Agreement Borrowings	Weighted Average Interest Rate on Borrowings Outstanding at end	Weighted Average Remaining Maturity (days)

		of period	
Agency RMBS	$ 3,046,358	0.38%	34
Non-Agency RMBS	468,664	1.61%	43
Agency and Non-Agency CMBS	288,025	1.52%	31
Other securities	79,080	1.54%	18
Total	$ 3,882,127	0.63%	35

Securities Pledged	Repurchase Agreement Borrowings	December 31, 2013 Weighted Average Interest Rate on Borrowings Outstanding at end of period	Weighted Average Remaining Maturity (days)
Agency RMBS	$ 2,331,276	0.43%	24
Non-Agency RMBS	208,923	1.71%	14
Agency and Non-Agency CMBS	17,544	1.33%	58
Other securities	21,324	1.68%	52
Total	$ 2,579,067	0.55%	24

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For the three and nine months ended September 30, 2014, the Company had average borrowings under its repurchase agreements of approximately $4.0 billion and $3.6 billion, respectively, and had a maximum month-end balance during the three and nine months ended of approximately $4.2 billion and $4.2 billion, respectively. The Company had accrued interest payable at September 30, 2014 of approximately $3.2 million. For the three and nine months ended September 30, 2013, the Company had average borrowings under its repurchase agreements of approximately $3.6 billion and $4.1 billion, respectively, had a maximum month-end balance during the three and nine months ended of approximately $4.0 billion and $4.8 billion, respectively, and had accrued interest payable of approximately $1.8 million at September 30, 2013.

The repurchase agreements bear interest at a contractually agreed-upon rate and typically have terms ranging from one month to three months. The Company s repurchase agreement borrowings are accounted for as secured borrowings when the Company maintains effective control of the financed assets. Under the repurchase agreements, the respective lender retains the right to determine the fair value of the underlying collateral. A reduction in the value of pledged assets requires the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, and is referred to as a margin call. The inability of the Company to post adequate collateral for a margin call by the counterparty, in a timeframe as short as the close of the same business day, could result in a condition of default under the Company s repurchase agreements, thereby enabling the counterparty to liquidate the collateral pledged by the Company, which may have a material adverse effect on the Company s financial position, results of operations and cash flows. During 2013, the volatility in both the Agency and Non-Agency MBS markets necessitated the Company being required to post additional collateral with respect to its repurchase agreements. The Company was able to satisfy the requirement for incremental collateral by utilizing unpledged assets, cash on hand, and reducing its overall leverage. In addition, during the second and third quarters of 2013, the Company also rehypothecated pledged U.S. Treasury securities it received from its interest rate swap counterparties as incremental collateral in order to generate additional cash proceeds in order to satisfy such margin requirements. The maximum amount of repurchase borrowings for the rehypothecated securities was $130.7 million during the year ended December 31, 2013. At September 30, 2014 and December 31, 2013, the Company did not have any rehypothecated U.S. Treasury securities.

A return of such volatility in these markets may create additional stress on the overall liquidity of the Company due to the long-term nature of its assets and the short-term nature of its liabilities. In an instance of severe volatility, or where the additional stress on liquidity resulting from volatility is sustained over an extended period of time, the Company could be required to sell securities, possibly even at a loss, to generate sufficient liquidity to satisfy collateral and margin requirements which could have a material adverse effect on the Company s financial position, results of operations and cash flows. All of the Company s repurchase agreement counterparties are either U.S. financial institutions or the U.S. broker-dealer subsidiaries of foreign financial institutions.

Further, if the Company is unable to renew, replace or expand repurchase financing with other sources of financing on substantially similar terms it may have a material adverse effect on the Company s financial position, results of operations and cash flow, due to the long term nature of the Company s investments and relatively short-term maturities of the Company s repurchase agreements. Certain of the repurchase agreements provide the counterparty with the right to terminate the agreement if the Company does not maintain certain equity and leverage metrics, the most restrictive of which include a limit on leverage based on the composition of the Company s portfolio.

At September 30, 2014, repurchase agreements collateralized by MBS and other securities had the following remaining maturities.

(dollars in thousands)		**Balance**
Overnight	$	32,960
1 to 29 days		1,964,858
30 to 59 days		1,251,358
60 to 89 days		616,710
90 to 119 days		16,241

Greater than or equal to 120 days		
Total	$	3,882,127

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As discussed in Note 2, for any transactions determined to be linked, the initial transfer and repurchase financing will be recorded as a forward commitment to purchase assets. At September 30, 2014, the Company had repurchase agreements of approximately $23.7 million that were accounted for as linked transactions. At December 31, 2013, the Company had repurchase agreements of approximately $61.2 million that were accounted for as linked transactions. Linked repurchase agreements are not included in the tables above. See Note 7 for details.

At September 30, 2014, the following table reflects amounts of collateral at risk under its repurchase agreements greater than 10% of the Company s equity with any counterparty, including linked transactions.

	September 30, 2014 (dollars in thousands)			
Counterparty		Amount Collateral at Risk, at fair value	Weighted Average Remaining Maturity (days)	Percentage of Stockholders Equity
Credit Suisse Securities (USA) LLC	$	80,960	22	12.7%
JP Morgan Securities LLC		74,982	39	11.8
Royal Bank of Canada		66,921	48	10.5

Note 6 Collateral Positions

The following tables summarize the Company s collateral positions, with respect to its borrowings under repurchase agreements, derivatives and clearing margin accounts at September 30, 2014 and December 31, 2013 (dollars in thousands):

	September 30, 2014					
		Assets Pledged- Fair Value		Accrued Interest		Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:						
Agency RMBS	$	3,197,721	$	12,969	$	3,210,690
Non-Agency RMBS		672,583		1,366		673,949
Agency and Non-Agency CMBS		378,717		1,915		380,632
Other securities		96,834		101		96,935
Cash (1)		27,861				27,861
Cash collateral for derivatives (1):		121,805				121,805
Total	$	4,495,521	$	16,351	$	4,511,872

	December 31, 2013					
		Assets Pledged- Fair Value		Accrued Interest		Fair Value of Assets Pledged and Accrued Interest
Assets pledged for borrowings under repurchase agreements:						
Agency RMBS	$	2,463,347	$	10,453	$	2,473,800
Non-Agency RMBS		305,318		417		305,735

Agency and Non-Agency CMBS		23,597		159		23,756
Other securities		26,685		26		26,711
Cash (1)		32,597				32,597
Cash collateral for derivatives (1):		22,837				22,837
Total	$	2,874,381	$	11,055	$	2,885,436

(1) Cash posted as collateral is included in Due from counterparties on the Company s Consolidated Balance Sheets.

A reduction in the value of pledged assets typically results in the repurchase agreement counterparties, derivative counterparties and clearing margin counterparties initiating a daily margin call. At September 30, 2014 and December 31, 2013, MBS and other securities held by counterparties as security for repurchase agreements totaled approximately $4.3 billion and approximately $2.8 billion, respectively. Cash collateral held by counterparties at September 30, 2014 and December 31, 2013 was approximately $149.7 million and $55.4 million, respectively. Cash posted by counterparties at September 30, 2014 and December 31, 2013, was approximately $3.3 million and $65.9 million, respectively. At September 30, 2014, the Company does not hold any securities received as collateral from its repurchase agreement and derivative counterparties.

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Note 7 Derivative Instruments

At September 30, 2014, the Company s derivatives include interest rate swaps (interest rate swaps), interest rate swaptions, currency swaps and forwards, futures contracts, TBAs, linked transactions, Agency and Non-Agency Interest-Only Strips that are classified as derivatives, and options.

Interest rate swaps and interest rate swaptions

The Company is exposed to certain risks arising from both its business operations and economic conditions. Specifically, the Company s primary source of debt funding is repurchase agreements and the Company enters into derivative financial instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates, the Company enters into interest rate swap agreements which help to mitigate the volatility in the interest rate exposures and their related cash flows. Interest rate swaps generally involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. Notwithstanding the foregoing, in order to manage its hedge position with regard to its liabilities, the Company on occasion will enter into interest rate swaps which involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the interest rate swap without exchange of the underlying notional amount. The Company also enters into interest rate swaptions to help mitigate the effects of increases in interest rates on a portion of its borrowings under repurchase agreements. Interest rate swaptions provide the Company the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future.

While the Company has not elected to account for its interest rate swap derivative instruments as hedges under GAAP, it does not use interest rate swaps and swaptions for speculative purposes, but rather uses such instruments to manage interest rate risk and views them as economic hedges. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in earnings together with periodic net interest settlement amounts.

The Company s interest rate swaps, interest rate swaptions, currency swaps and forwards, futures contracts, TBA derivative instruments, options and linked transactions consisted of the following at September 30, 2014 and December 31, 2013 (dollars in thousands):

			September 30, 2014		
Derivative Instrument	**Designation**	**Consolidated Balance Sheets Location**	**Notional Amount**	**Fair Value, excluding accrued interest**	**Accrued Interest Payable**
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	$ 4,394,900	$ 34,834	$ 210
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	805,000	347	
Options, assets	Non-Hedge	Derivative assets, at fair value	1,000,000	2,473	
Futures contracts, assets	Non-Hedge	Derivative assets, at fair value	592,000	104	
Foreign currency swaps, asset	Non-Hedge	Derivative assets, at fair value	25,160	2,072	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	2,565,000	2,390	
				42,220	210

Total derivative instruments, assets							
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	6,763,330		(87,111)		2,572
Interest rate swaptions, liability	Non-Hedge	Derivative liability, at fair value	540,000		(2,571)		
Futures contract, liability	Non-Hedge	Derivative liability, at fair value	592,000		(414)		
Foreign currency forward contracts, liability	Non-Hedge	Derivative liability, at fair value	14,104		(81)		
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	2,089,000		(2,041)		
Total derivative instruments, liabilities					(92,218)		2,572
Linked transactions (1)	Non-Hedge	Linked transactions, net, at fair value	37,839		13,917		(29)
Total derivative instruments				$	(36,081)	$	2,753

(1) Notional amount represents the current face of the securities comprising the linked transactions.

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			December 31, 2013		
Derivative Instrument	**Designation**	**Consolidated Balance Sheets Location**	**Notional Amount**	**Fair Value, excluding accrued interest**	**Accrued Interest Payable**
Interest rate swaps, assets	Non-Hedge	Derivative assets, at fair value	$ 2,135,950	$ 94,614	$ 9,994
Interest rate swaptions, assets	Non-Hedge	Derivative assets, at fair value	2,200,000	11,177	
TBA securities, assets	Non-Hedge	Derivative assets, at fair value	13,600	35	
Total derivative instruments, assets				105,826	9,994
Interest rate swaps, liability	Non-Hedge	Derivative liability, at fair value	678,900	(3,202)	(26)
Interest rate swaptions, liability	Non-Hedge	Derivative liability, at fair value	100,000	(264)	
TBA securities, liabilities	Non-Hedge	Derivative liability, at fair value	176,400	(1,207)	
Total derivative instruments, liabilities				(4,673)	(26)
Linked transactions (1)	Non-Hedge	Linked transactions, net, at fair value	56,028	18,559	(207)
Total derivative instruments				119,712	$ 9,761

(1) Notional amount represents the current face of the securities comprising the linked transactions.

The following tables summarize the average fixed pay rate and average maturity for the Company s interest rate swaps as of September 30, 2014 and December 31, 2013 (excludes interest rate swaptions) (dollars in thousands):

	September 30, 2014			
Remaining Interest Rate interest rate swap Term	**Notional Amount**	**Average Fixed Pay Rate**	**Average Maturity (Years)**	**Forward Starting**
1 year or less	$ 139,500	0.4%	0.1	%
Greater than 1 year and less than 3 years	1,464,100	0.8	1.9	27.3
Greater than 3 years and less than 5 years	2,801,780	1.8	4.6	
Greater than 5 years	3,377,450	3.0	11.0	45.4
Total	$ 7,782,830	2.1%	6.8	24.8%

	December 31, 2013			
Remaining Interest Rate interest rate swap Term	**Notional Amount**	**Average Fixed Pay Rate**	**Average Maturity (Years)**	**Forward Starting**
1 year or less	$ 215,900	0.4%	0.8	%
Greater than 1 year and less than 3 years	179,100	0.5	1.9	
Greater than 3 years and less than 5 years	574,200	1.3	4.4	
Greater than 5 years	1,718,650	2.4	10.8	28.6
Total	$ 2,687,850	1.9%	8.0	18.3%

The Company has entered into swaps to effectively fix the interest rate (for the life of the swap); net of variable-rate payment swaps, of approximately $2.6 billion of borrowings under its repurchase agreements, excluding forward starting swaps of $1.8 billion.

The following tables summarize the average variable pay rate and average maturity for the Company s interest rate swaps as of September 30, 2014 and December 31, 2013 (excludes interest rate swaptions) (dollars in thousands):

	September 30, 2014			
Remaining Interest Rate interest rate swap Term	**Notional Amount**	**Average Variable Pay Rate**	**Average Maturity (Years)**	**Forward Starting**
Greater than 3 years and less than 5 years	$ 1,749,600	0.2%	4.6	0.0%
Greater than 5 years	1,625,800	0.2	11.2	6.8
Total	$ 3,375,400	0.2%	7.8	3.3%

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	December 31, 2013			
Remaining Interest Rate interest rate swap Term	Notional Amount	Average Variable Pay Rate	Average Maturity (Years)	Forward Starting
Greater than 3 years and less than 5 years	$ 81,000	0.2%	4.8	%
Greater than 5 years	46,000	0.2	24.1	
Total	$ 127,000	0.2%	11.8	%

The Company s agreements with certain of its bilateral interest rate swap counterparties may be terminated at the option of the counterparty if the Company does not maintain certain equity and leverage metrics, the most restrictive of which contain provisions which become more restrictive based upon portfolio composition. Through September 30, 2014, the Company was in compliance with the terms of such financial tests.

The following tables present information about the Company s interest rate swaptions as of September 30, 2014 and December 31, 2013 (dollars in thousands):

	September 30, 2014			
	Option		Underlying Swap	
Fixed-Pay Rate for Underlying Swap	Fair Value	Weighted Average Months Until Option Expiration	Notional Amount	Weighted Average Swap Term (Years)
1.51 1.75%	$ 35	1.6	$ 500,000	5.0
2.26 2.50%	312	20.8	105,000	1.0
3.51 3.75%		0.6	200,000	10.0
	$ 347	3.8	$ 805,000	5.7

	September 30, 2014			
	Option		Underlying Swap	
Fixed-Receive Rate for Underlying Swap	Fair Value	Weighted Average Months Until Option Expiration	Notional Amount	Weighted Average Swap Term (Years)
2.76 3.00%	$ (2,571)	2.1	$ 540,000	10.0
	$ (2,571)	2.1	$ 540,000	10.0

	December 31, 2013			
	Option		Underlying Swap	
Fixed-Pay Rate for Underlying Swap	Fair Value	Weighted Average Months Until Option Expiration	Notional Amount	Weighted Average Swap Term (Years)
2.51 2.75%	$ 1,889	4.4	$ 150,000	7.0
2.76 3.00%	2,762	4.3	250,000	7.0
3.01 3.25%	1,192	4.6	1,500,000	10.0
3.26 3.50%	971	4.0	100,000	10.0
3.51 3.75%	4,363	9.6	200,000	10.0
	$ 11,177	5.0	$ 2,200,000	9.5

	December 31, 2013			
	Option		Underlying Swap	
Fixed-Receive Rate for Underlying Swap	Fair Value	Weighted Average Months Until Option Expiration	Notional Amount	Weighted Average Swap Term (Years)
3.76 4.00%	$ (264)	4.0	$ 100,000	10.0
	$ (264)	4.0	$ 100,000	10.0

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The Company has minimum collateral posting thresholds with certain of its derivative counterparties, including with its clearing broker for cleared swaps, for which it typically pledges cash. As of September 30, 2014 and December 31, 2013, the Company had cash pledged as collateral of approximately $121.8 million and $22.8 million, respectively, which is reported on the Consolidated Balance Sheets as Due from counterparties. The Company received cash of approximately $2.4 million and $62.7 million as collateral against derivatives at September 30, 2014 and December 31, 2013, respectively, which is reported on the Consolidated Balance Sheets as Due to counterparties. As of September 30, 2014, the Company has swaps with two counterparties that are based in England and Switzerland, with fair values in a liability position of $156 thousand and fair values in an asset position of approximately $1.8 million and notional balances of $49.3 million and $303.4 million, respectively. At December 31, 2013, the Company had swaps with fair values in an asset position of $19.4 million and $34.2 million and notional balances of $321.8 million and $825.1 million with these two counterparties. Included in the $2.4 million and $62.7 million received by the Company is cash posted as collateral by these two counterparties of approximately $1.8 million and $42.7 million at September 30, 2014 and December 31, 2013, respectively.

Currency Swaps and Forwards

The Company has invested in and, in the future, may invest in additional securities which are denominated in a currency or currencies other than U.S. dollars. Similarly, it has and may in the future, finance such assets in a currency or currencies other than U.S. dollars. In order to mitigate the impact to the Company may enter into derivative financial instruments, including foreign currency swaps and foreign currency forwards, to manage of fluctuations in the valuation between U.S. dollars and such foreign currencies. Foreign currency swaps involve the payment of a foreign currency at fixed interest on a fixed notional amount and the receipt of U.S. dollars at a fixed interest rate on a fixed notional amount. Foreign currency forwards provide for the payment of a fixed amount of a foreign currency in exchange for a fixed amount of U.S. dollars at a date certain in the future. The carrying value of foreign currency swaps and forwards is included in Derivative assets (liabilities), at fair value on the Consolidated Balance Sheets with changes in valuation included in Gain (loss) on derivative instruments, net on the Consolidated Statement of Operations. The following is a summary of the Company s foreign currency forwards with a fair value in a liability position of $81 thousand at September 30, 2014:

Derivative Type	Notional Amount	Notional (USD Equivalent)	Maturity
Buy EUR/Sell USD Currency forward	11,100	$ 14,113	December 2014

The following is a summary of the Company s foreign currency swaps with a fair value of $2.1 million at September 30, 2014:

Date entered	Maturity	Fixed Rate	Denomination	Notional Amount
June 2014	July 2024	7.25%	EUR	18,500
June 2014	July 2024	9.005%	USD	25,160

Interest-Only Strips

The Company also invests in Interest-Only Strips. In determining the classification of its holdings of Interest-Only Strips, the Company evaluates the securities to determine if the nature of the cash flows has been altered from that of the underlying mortgage collateral. Generally, Interest-Only Strips for which the security represents a strip off of a mortgage pass through security will be considered a hybrid instrument classified as a MBS investment on the Consolidated Balance Sheets utilizing the fair value option. Alternatively, those Interest-Only

Strips, for which the underlying mortgage collateral has been included into a structured security that alters the cash flows from the underlying mortgage collateral, are accounted for as derivatives at fair value with changes recognized in Gain (loss) on derivative instruments, net in the Consolidated Statement of Operations, along with any interest received. The carrying value of these Interest-Only Strips is included in Mortgage-backed securities on the Consolidated Balance Sheets.

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To-be-announced securities

The Company also purchased or sold TBAs. As of September 30, 2014 and December 31, 2013, the Company had contracts to purchase (long position) and sell (short position) TBAs on a forward basis. Following is a summary of the Company s long and short TBA positions reported in Derivative assets, at fair value on the Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013 (dollars in thousands):

	September 30, 2014		December 31, 2013	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Purchase contracts, asset	$ 1,915,000	$ 1,225	$ 13,600	$ 35
Sale contracts, asset	(650,000)	1,165		
TBA securities, asset	1,265,000	2,390	13,600	35
Purchase contracts, liability	969,500	(1,357)	176,400	(1,207)
Sale contracts, liability	(1,119,500)	(684)		
TBA securities, liability	(150,000)	(2,041)	176,400	(1,207)
TBA securities, net	$ 1,115,000	$ 349	$ 190,000	$ (1,172)

The following table presents additional information about the Company s contracts to purchase and sell TBAs for the nine months ended September 30, 2014 (dollars in thousands):

	Notional Amount as of December 31, 2013	Additions	Settlement, Termination, Expiration or Exercise	Notional Amount as of September 30, 2014
Purchase of TBAs	$ 190,000	17,693,696	$ (14,999,196)	$ 2,884,500
Sale of TBAs	$	16,768,696	$ (14,999,196)	$ 1,769,500

Futures Contracts

The Company also entered into Eurodollar futures during the nine months ended September 30, 2014. As of September 30, 2014, the Company had purchase contracts (long position), representing a notional amount of $592.0 million with a fair value of $104 thousand and an expiration date of June 2016. In addition, as of September 30, 2014, the Company had contracts to sell (short position), representing a notional amount of $592.0 million with a fair value in a liability position of $414 thousand and an expiration date of June 2018.

Gain (loss) on derivative instruments

The below tables summarize the effect of interest rate swaps, interest rate swaptions, foreign currency swaps, foreign currency forwards, options, futures contracts, Agency and Non-Agency Interest-Only Strips as derivatives and TBAs reported in Gain (loss) on derivative instruments, net on our Consolidated Statement of Operations for the three and nine months ended September 30, 2014 and 2013 (dollars in thousands):

Description	Three months ended September 30, 2014				
	Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to-market adjustments	Total
Interest rate swaps	$ 23,798	$ (11,848)	$	$ (14,767)	$ (2,817)
Interest rate swaptions				(624)	(624)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	389	5,723	(4,187)	(915)	1,010
Options				(340)	(340)
Futures contracts				(200)	(200)
Foreign currency forwards	(1,182)			57	(1,125)
Foreign currency swaps		140		2,057	2,197
TBAs	2,608			(1,110)	1,498
Total	$ 25,613	$ (5,985)	$ (4,187)	$ (15,842)	$ (401)

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Description	Nine months ended September 30, 2014 Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to-market adjustments	Total
Interest rate swaps	$ 39,796	$ (25,784)	$	$ (144,882)	$ (130,870)
Interest rate swaptions	(5,908)			(5,615)	(11,523)
Agency and Non-Agency Interest-Only Strips accounted for as derivatives	(755)	20,288	(14,286)	(332)	4,915
Options				(340)	(340)
Futures contracts	(16,495)			(311)	(16,806)
Foreign currency forwards	(1,182)			(81)	(1,263)
Foreign currency swaps		141		2,072	2,213
TBAs	25,169			1,521	26,690
Total	$ 40,625	$ (5,355)	$ (14,286)	$ (147,968)	$ (126,984)

Description	Three months ended September 30, 2013 Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to-market adjustments	Total
Interest rate swaps	$ 23,166	$ (6,158)	$	$ (28,891)	$ (11,883)
Interest rate swaptions	22,633			(16,065)	6,568
Agency and Non-Agency Interest-Only Strips accounted for as derivatives		6,993	(4,040)	(4,824)	(1,871)
TBAs	1,016			2,361	3,377
Total	$ 46,815	$ 835	$ (4,040)	$ (47,419)	$ (3,809)

Description	Nine months ended September 30, 2013 Realized Gain (Loss), net	Contractual interest income (expense), net(1)	Basis Recovery	Mark-to-market adjustments	Total
Interest rate swaps					