Armour Residential REIT, Inc.
Form 10-Q
October 28, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2013

OR

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

For the transition period from __________ to __________

ARMOUR RESIDENTIAL REIT, INC.

(Exact name of registrant as specified in its charter)

Maryland	**001-34766**	**26-1908763**
(State or other jurisdiction of incorporation or organization)	(Commission File Number)	(I.R.S. Employer Identification No.)

3001 Ocean Drive, Suite 201, Vero Beach, FL 32963

(Address of principal executive offices)(zip code)

(772) 617-4340

(Registrant’s telephone number, including area code)

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

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

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

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

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

The number of outstanding shares of the Registrant’s common stock as of October 25, 2013 was 370,905,142.

ARMOUR Residential REIT, Inc.

TABLE OF CONTENTS

ARMOUR Residential REIT, Inc. and Subsidiary

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(Unaudited)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

	September 30, 2013	**December 31, 2012**
Assets		
Cash and cash equivalents	$496,480	$771,282
Cash collateral posted	30,962	265,552
Agency Securities, available for sale, at fair value (including pledged securities of $15,811,765 and $18,578,690)	16,664,917	19,096,562
Receivable for unsettled sales	-	668,244
Derivatives, at fair value	390,685	5,367
Principal payments receivable	256	16,037
Accrued interest receivable	45,985	55,430
Prepaid and other assets	1,184	404
Total Assets	$17,630,469	$20,878,878
Liabilities and Stockholders' Equity		
Liabilities:		
Repurchase agreements	$14,917,525	$18,366,095
Cash collateral held	294,071	-
Payable for unsettled purchases	143,894	-
Derivatives, at fair value	110,017	190,540
Accrued interest payable	7,816	10,064
Accounts payable and other accrued expenses	3,697	4,395
Dividends payable	-	9
Total Liabilities	$15,477,020	$18,571,103
Commitments and contingencies (Note 9)		
Stockholders' Equity:		

Preferred stock, $0.001 par value, 50,000 shares authorized;		
8.250% Series A Cumulative Preferred Stock; 2,181 and 2,006 issued and outstanding at September 30, 2013 and December 31, 2012	2	2
7.875% Series B Cumulative Preferred Stock; 5,650 and none issued and outstanding at September 30, 2013 and December 31, 2012	6	-
Common stock, $0.001 par value, 1,000,000 shares authorized, 370,905 and 309,013 shares issued and outstanding at September 30, 2013 and December 31, 2012	371	309
Additional paid-in capital	2,786,559	2,226,198
Accumulated deficit	(42,635)	(149,298)
Accumulated other comprehensive income (loss)	(590,854)	230,564
Total Stockholders' Equity	$2,153,449	$2,307,775
Total Liabilities and Stockholders' Equity	$17,630,469	$20,878,878

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiary

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(Unaudited)

	For the Quarters Ended		For the Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Interest income, net of amortization of premium on Agency Securities	$112,418	$116,693	$384,215	$265,660
Interest expense	(17,899)	(19,222)	(66,969)	(37,258)
Net interest income	$94,519	$97,471	$317,246	$228,402
Other Income (Loss):				
Realized gain (loss) on sale of Agency Securities (reclassified from Other comprehensive income (loss))	(300,960)	15,062	(261,569)	20,110
Gain on short sale of U.S. Treasury Securities	35,255	-	14,176	-
Other income	-	-	-	1,043
Subtotal	$(265,705)	$15,062	$(247,393)	$21,153
Realized loss on derivatives (1)	(37,262)	(18,914)	(105,173)	(41,055)
Unrealized gain (loss) on derivatives	(11,821)	(31,486)	416,662	(84,265)
Subtotal	$(49,083)	$(50,400)	$311,489	$(125,320)
Total Other Income (Loss)	$(314,788)	$(35,338)	$64,096	$(104,167)
Expenses:				
Management fee	6,483	5,545	20,985	13,356
Professional fees	773	472	2,299	1,408
Insurance	188	85	355	189
Compensation	1,859	426	2,373	1,417
Other	381	660	1,608	1,331
Total expenses	$9,684	$7,188	$27,620	$17,701
Income (loss) before taxes	(229,953)	54,945	353,722	106,534
Income tax benefit (expense)	10	(3)	10	27
Net Income (Loss)	$(229,943)	$54,942	$353,732	$106,561
Dividends declared on preferred stock	(3,905)	(804)	(10,308)	(964)
Net Income (Loss) available (related) to common stockholders	$(233,848)	$54,138	$343,424	$105,597
Net income (loss) available (related) per share to common stockholders (Note 12):				
Basic	$(0.63)	$0.20	$1.28	$0.54
Diluted	$(0.63)	$0.20	$1.27	$0.54
Dividends declared per common share	$0.21	$0.30	$0.66	$0.92
Weighted average common shares outstanding:				

Basic	370,818	269,325	268,202	195,272
Diluted	372,256	270,010	269,636	196,287

(1) Interest expense related to our interest rate swap contracts is recorded in realized loss on derivatives on the condensed consolidated statements of operations. For additional information, see Note 8 to the condensed consolidated financial statements.

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiary

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(Unaudited)

	For the Quarters Ended		For the Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Net Income (Loss)	$(229,943)	$ 54,942	$353,732	$ 106,561
Other comprehensive income (loss):				
Reclassification adjustment for realized (gain) loss on sale of available for sale Agency Securities	300,960	(15,062)	261,569	(20,110)
Net unrealized gain (loss) on available for sale Agency Securities	(51,778)	250,062	(1,082,987)	374,012
Other comprehensive income (loss)	$249,182	$ 235,000	$(821,418)	$ 353,902
Comprehensive Income (Loss)	$19,239	$ 289,942	$(467,686)	$ 460,463

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiary

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(in thousands, except per share amounts)

(Unaudited)

	Preferred Stock 8.250% Series A			**7.875% Series B**			**Common Stock**					
	Shares	**Par Amount**	**Additional Paid in Capital**	**Shares**	**Par Amount**	**Additional Paid in Capital**	**Shares**	**Par Amount**	**Additional Paid in Capital**	**Total Additional Paid in Capital**	**(Accumulated Deficit)**	**Acc Oth Con Inco (Los**
Balance, January 1, 2013	2,006	$2	$48,792	-	$-	$-	309,013	$309	$2,177,406	$2,226,198	$(149,298)	$23
Series A Preferred dividends declared	-	-	-	-	-	-	-	-	-	-	(3,356)	-
Series B Preferred dividends declared	-	-	-	-	-	-	-	-	-	-	(6,952)	-
Common stock dividends declared	-	-	-	-	-	-	-	-	-	-	(236,761)	-
Issuance of Series A Preferred stock, net	175	-	4,380	-	-	-	-	-	-	4,380	-	-
Issuance of Series B Preferred stock, net	-	-	-	5,650	6	136,547	-	-	-	136,547	-	-
Issuance of common stock, net	-	-	-	-	-	-	65,056	65	438,470	438,470	-	-
Stock based compensation, net of	-	-	-	-	-	-	232	1	1,220	1,220	-	-

withholding requirements												
Common stock repurchased	-	-	-	-	-	-	(3,396)	(4)	(20,256)	(20,256)	-	-
Net income	-	-	-	-	-	-	-	-	-	-	353,732	-
Other comprehensive loss	-	-	-	-	-	-	-	-	-	-	-	(82
Balance, September 30, 2013	2,181	$2	$53,172	5,650	$6	$136,547	370,905	$371	$2,596,840	$2,786,559	$(42,635)	$(59

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiary

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	For the Nine Months Ended	
	September 30, 2013	September 30, 2012
Cash Flows From Operating Activities:		
Net income	$353,732	$106,561
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of premium on Agency Securities	140,091	71,168
Realized (gain) loss on sale of Agency Securities	261,569	(20,110)
Gain on short sale of U.S. Treasury Securities	(14,176)	-
Stock based compensation	1,221	526
Changes in operating assets and liabilities:		
Decrease (increase) in accrued interest receivable	9,445	(41,660)
Increase in prepaid and other assets	(773)	(333)
Decrease (increase) in derivatives, at fair value	(447,943)	68,603
Increase (decrease) in accrued interest payable	(2,248)	7,148
Increase (decrease) in accounts payable and other accrued expenses	(698)	1,861
Net cash provided by operating activities	$300,220	$193,764
Cash Flows From Investing Activities:		
Purchases of Agency Securities	(12,392,749)	(18,916,083)
Principal repayments of Agency Securities	2,795,559	1,574,116
Proceeds from sales of Agency Securities	11,615,779	1,869,332
Disbursements on reverse repurchase agreements	(11,239,305)	-
Receipts from reverse repurchase agreements	11,239,305	-
Decrease (increase) in cash collateral	528,661	(90,590)
Net cash provided by (used in) investing activities	$2,547,250	$(15,563,225)
Cash Flows From Financing Activities:		
Issuance of Series A Preferred stock, net of expenses	4,380	43,041
Issuance of Series B Preferred stock, net of expenses	136,553	-
Issuance of common stock, net of expenses	438,528	1,498,157
Proceeds from repurchase agreements	99,907,622	92,966,646
Principal repayments on repurchase agreements	(103,356,193)	(78,476,690)
Proceeds from sales of U.S. Treasury Securities	2,789,560	-
Purchases of U.S. Treasury Securities	(2,775,384)	-
Series A Preferred stock dividends paid	(3,356)	(964)
Series B Preferred stock dividends paid	(6,952)	-
Common stock dividends paid	(236,770)	(185,795)

Common stock repurchased	(20,260)	-
Net cash provided by (used in) financing activities	$(3,122,272)	$15,844,395
Net increase (decrease) in cash	(274,802)	474,934
Cash and cash equivalents - beginning of period	771,282	252,372
Cash and cash equivalents- end of period	$496,480	$727,306
Supplemental Disclosure:		
Cash paid during the period for interest	$198,131	$61,245
Non-Cash Investing and Financing Activities:		
Receivable for unsettled sales	$-	$357,218
Payable for unsettled purchases	$143,894	$1,036,450
Net unrealized gain (loss) on available for sale Agency Securities	$(1,082,987)	$374,012
Amounts receivable for issuance of common stock	$7	$5
Amounts receivable for issuance of preferred stock	$-	$263

See notes to condensed consolidated financial statements

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 – Basis of Presentation

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 1001 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2013. These unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2012.

The condensed consolidated financial statements include the accounts of ARMOUR Residential REIT, Inc. and its subsidiary. All intercompany accounts and transactions have been eliminated. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the accompanying condensed consolidated financial statements include the valuation of Agency Securities (as defined below) and derivative instruments.

Note 2 – Organization and Nature of Business Operations

References to “we,” “us,” “our,” "ARMOUR" or the “Company” are to ARMOUR Residential REIT, Inc. References to "ARRM" are to ARMOUR Residential Management LLC, a Delaware limited liability company. References to “Enterprise” are to Enterprise Acquisition Corp., which is a wholly-owned subsidiary of ARMOUR.

We are an externally managed Maryland corporation organized in 2008, managed by ARRM (see Note 14, *“Related Party Transactions”* for additional discussion). We invest in residential mortgage backed securities issued or guaranteed by a United States (“U.S.”) Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) or guaranteed by the

Government National Mortgage Administration (Ginnie Mae) (collectively, "Agency Securities"). As of September 30, 2013 and December 31, 2012, Agency Securities accounted for 100% of our securities portfolio. It is expected that the percentage will continue to be 100% or close thereto. Our securities portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs (“Agency Debt”), U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust (“REIT”). On December 1, 2011, our stockholders approved an amendment to our charter to alter our investment asset class restriction in response to potential changes in Agency Securities to include Non-Agency Securities as well as Agency Securities in our investment asset class restriction. While we remain committed to investing in Agency Securities for so long as an adequate supply and pricing exists, we believe it is prudent for us to have the flexibility to invest in Non-Agency Securities and respond to changes in GSE policy.

We have elected to be taxed as a REIT under the Internal Revenue Code (“the Code”). Our qualification as a REIT depends on our ability to meet, on a continuing basis, various complex requirements under the Code relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the concentration of ownership of our capital stock. We believe that we are organized in conformity with the requirements for qualification as a REIT under the Code and our manner of operations enables us to meet the requirements for taxation as a REIT for federal income tax purposes.

As a REIT, we will generally not be subject to federal income tax on the REIT taxable income that we currently distribute to our stockholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to federal income tax at regular corporate rates. Even if we qualify as a REIT for federal income tax purposes, we may still be subject to some federal, state and local taxes on our income.

Note 3 – Summary of Significant Accounting Policies

Cash and cash equivalents

Cash and cash equivalents includes cash on deposit with financial institutions and investments in high quality overnight money market funds, all of which have original maturities of three months or less, at the time of purchase. We may maintain deposits in federally insured financial institutions in excess of federally insured limits. However, management believes we are not exposed to significant credit risk due to the financial position and creditworthiness of the depository institutions in which those deposits are held.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Cash Collateral Posted/Held

The following table presents information related to margin collateral posted (held) for Agency Securities, interest rate swap contracts and Eurodollar Futures Contracts ("Futures Contracts") which are included in cash collateral on the accompanying condensed consolidated balance sheets as of September 30, 2013 and December 31, 2012.

September 30, 2013

	Assets at Fair Value (1)	**Liabilities at Fair Value (1)**
	(in thousands)	
Agency Securities	$618	$(61,276)
Interest rate swap contracts	28,144	(232,795)
Futures Contracts	2,200	-
Totals	$30,962	$(294,071)

(1) See Note 5, *"Fair Value of Financial Instruments"* for additional discussion.

December 31, 2012

	Assets at Fair Value (1)	**Liabilities at Fair Value (1)**
	(in thousands)	

Interest rate swap contracts	$261,364	$ -
Futures Contracts	4,188	-
Totals	$265,552	$ -

(1) See Note 5, *"Fair Value of Financial Instruments"* for additional discussion.

Agency Securities, at Fair Value

We generally intend to hold most of our Agency Securities for extended periods of time. We may, from time to time, sell any of our Agency Securities as part of the overall management of our securities portfolio. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. As of September 30, 2013 and December 31, 2012, all of our Agency Securities were classified as available for sale. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the condensed consolidated statements of comprehensive income (loss).

We evaluate Agency Securities for other than temporary impairment at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. We consider an impairment to be other than temporary if we (1) have the intent to sell the Agency Securities, (2) believe it is more likely than not that we will be required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations) or (3) a credit loss exists.

Accrued Interest Receivable and Payable

Accrued interest receivable includes interest accrued between payment dates on Agency Securities. Accrued interest payable includes interest payable on our repurchase agreements.

Repurchase Agreements

We finance the acquisition of our Agency Securities through the use of repurchase agreements. Our repurchase agreements are secured by our Agency Securities and bear interest rates that have historically moved in close relationship to the Federal Funds Rate and the London Interbank Offered Rate ("LIBOR"). Under these repurchase agreements, we sell Agency Securities to a lender and agree to repurchase the same Agency Securities in the future for a price that is higher than the original sales price. The difference between the sales price that we receive and the repurchase price that we pay represents interest paid to the lender. A repurchase agreement operates as a financing arrangement under which we pledge our Agency Securities as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. We retain beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral from the lender or, with the consent of the lender, we may renew such agreement at the then prevailing interest rate. The repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of the existing pledged collateral declines.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement, settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding at September 30, 2013 or December 31, 2012.

Obligations to Return Securities Received as Collateral, at Fair Value

At certain times, we also sell to third parties the U.S. Treasury Securities received as collateral for reverse repurchase agreements and recognize the resulting obligation to return said U.S. Treasury Securities as a liability on our condensed consolidated balance sheets. Interest is recorded on the repurchase agreements, reverse repurchase agreements and U.S. Treasury Securities on an accrual basis and presented as net interest expense. Both parties to the transaction have the right to make daily margin calls based on changes in the fair value of the collateral received and/or pledged. We did not have any reverse repurchase agreements outstanding at September 30, 2013 or December 31, 2012.

Derivatives, at Fair Value

We recognize all derivatives as either assets or liabilities at fair value on our condensed consolidated balance sheets. We do not designate our derivatives as cash flow hedges, which, among other factors, would require us to match the pricing dates of both derivatives and repurchase agreements. Operational issues and credit market volatility make such matching impractical for us. Since we have not elected cash flow hedge accounting treatment as allowed by GAAP, all changes in the fair values of our derivatives are reflected in our condensed consolidated statements of operations. Accordingly, our operating results may reflect greater volatility than otherwise would be the case, because gains or losses on derivatives may not be offset by changes in the fair value or cash flows of the transaction within the same accounting period or ever. Consequently, any declines in the fair value of our derivatives result in a charge to earnings. We will continue to designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable income.

Credit Risk

We have limited our exposure to credit losses on our securities portfolio of Agency Securities. The payment of principal and interest on the Freddie Mac and Fannie Mae Agency Securities are guaranteed by those respective agencies and the payment of principal and interest on the Ginnie Mae Agency Securities are backed by the full faith and credit of the U.S. Government.

In September 2008, both Freddie Mac and Fannie Mae were placed in the conservatorship of the U.S. Government. On August 5, 2011, Standard & Poor's Corporation downgraded the U.S. Government's credit rating from AAA to AA+ and on August 8, 2011, Fannie Mae and Freddie Mac's credit ratings were downgraded from AAA to AA+. Fannie Mae and Freddie Mac remain in conservatorship of the U.S. Government. There can be no assurances as to how or when the U.S. Government will end these conservatorships or how the future profitability of Fannie Mae and Freddie Mac and any future credit rating actions may impact the credit risk associated with Agency Securities and, therefore, the value of the Agency Securities in our securities portfolio.

Market Risk

Weakness in the mortgage market may adversely affect the performance and market value of our investments. This could negatively impact our book value. Furthermore, if our lenders are unwilling or unable to provide additional financing, we could be forced to sell our Agency Securities at an inopportune time when prices are depressed.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Preferred Stock

At September 30, 2013, we were authorized to issue up to 50,000,000 shares of preferred stock, par value $0.001 per share with such designations, voting and other rights and preferences as may be determined from time to time by our Board of Directors ("Board") or a committee thereof.

Series A Cumulative Preferred Shares ("Series A Preferred Stock")

On June 6, 2012, we filed with the Maryland State Department of Assessments and Taxation to designate 1,610,000 shares of the 50,000,000 authorized preferred stock as 8.250% Series A Preferred Stock with the powers, designations, preferences and other rights as set forth therein. On July 13, 2012, we entered into an At Market Issuance Sales Agreement with MLV & Co. LLC, as our agent, to offer and sell, from time to time, up to 6,000,000 shares of Series A Preferred Stock. On July 27, 2012, we entered into an Equity Distribution Agreement with Citadel Securities LLC, as our agent, to offer and sell, from time to time, up to 2,000,000 shares of Series A Preferred Stock. At September 30, 2013, there were 9,610,000 shares designated as Series A Preferred Stock.

We had 2,180,572 shares of Series A Preferred Stock issued and outstanding at September 30, 2013 and 2,005,611 shares of Series A Preferred Stock issued and outstanding at December 31, 2012. Our Series A Preferred Stock has a par value of $0.001 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends. The Series A Preferred Stock is entitled to a dividend at a rate of 8.250% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on June 7, 2017 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series A Preferred Stock is senior to our common stock and therefore in the event of liquidation, dissolution or winding up, the Series A Preferred Stock will receive a liquidation preference of $25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series A Preferred Stock generally does not have voting rights except if we fail to pay dividends on the Series A Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series A Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series A Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series A Preferred Stock.

Series B Cumulative Preferred Shares ("Series B Preferred Stock")

On February 11, 2013, we filed with the Maryland State Department of Assessments and Taxation to designate 6,210,000 shares of the 50,000,000 authorized preferred stock as 7.875% Series B Preferred Stock with the powers, designations, preferences and other rights as set forth therein.

We had 5,650,000 shares of Series B Preferred Stock issued and outstanding at September 30, 2013 and none issued and outstanding at December 31, 2012. Our Series B Preferred Stock has a par value of $0.001 per share and a liquidation preference of $25.00 per share plus accrued and unpaid dividends. The Series B Preferred Stock is entitled to a dividend at a rate of 7.875% per year based on the $25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series B Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on February 12, 2018 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series B Preferred Stock is senior to our common stock and rank on parity with the Series A Preferred Stock. In the event of liquidation, dissolution or winding up, the Series B Preferred Stock will receive a liquidation preference of $25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series B Preferred Stock generally does not have voting rights except if we fail to pay dividends on the Series B Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series B Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series B Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series B Preferred Stock.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Common Stock

Common Stock and Warrants

At September 30, 2013, we were authorized to issue up to 1,000,000,000 shares of common stock, par value $0.001 per share, with such designations, voting and other rights and preferences as may be determined from time to time by our Board. We had 370,905,142 shares of common stock issued and outstanding at September 30, 2013 and 309,013,984 shares of common stock issued and outstanding at December 31, 2012. We had outstanding warrants whereby their holders have the right to purchase 32,500,000 shares of our common stock at September 30, 2013 and December 31, 2012. These warrants are exercisable at $11.00 per share and expire on November 7, 2013. The warrants are listed on the NYSE MKT LLC which has determined that November 1, 2013, will be the final trading day for the warrants.

Common Stock Repurchased

On December 17, 2012, we announced that our Board had authorized a stock repurchase program of up to $100 million of shares of our common stock outstanding (the “Repurchase Program”). Under the Repurchase Program shares may be purchased in the open market, including block trades, through privately negotiated transactions, or pursuant to a trading plan separately adopted in the future. The timing, manner, price and amount of any repurchases will be at our discretion, subject to the requirements of the Securities Exchange Act of 1934, as amended, and related rules. We are not required to repurchase any shares under the Repurchase Program and it may be modified, suspended or terminated at any time for any reason. We do not intend to purchase shares from our Board or other affiliates. Under Maryland law, such repurchased shares are treated as authorized but unissued. As of September 30, 2013, we repurchased 3,395,603 shares of our common stock under the Repurchase Program for an aggregate of $20.3 million.

Revenue Recognition

Interest income is earned and recognized on Agency Securities based on their unpaid principal amounts and their contractual terms. Premiums and discounts associated with the purchase of Agency Securities are amortized or accreted into interest income over the actual lives of the securities.

Comprehensive Income (Loss)

Comprehensive income (loss) refers to changes in equity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Note 4 – Recent Accounting Pronouncements

In January 2013, the Financial Accounting Standards Board ("FASB") issued *ASU 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, Balance Sheet (Topic 210).* This update to ASU 2011-11 addressed implementation issues and applied to derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with ASC 210-20-45 or ASC 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The guidance was effective January 1, 2013 and was applied retrospectively. This guidance did not affect the presentation of Derivatives, at fair value on our condensed consolidated balance sheets and therefore, did not affect our financial statements.

In February 2013, the FASB issued *ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, Comprehensive Income (Topic 220).* This update to ASU 2011-12 addressed improving the reporting of reclassifications out of accumulated other comprehensive income by requiring reporting of the effect of significant reclassifications out of accumulated net income if the amount being reclassified is required under GAAP to be classified in its entirety to net income. For amounts not required to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about these amounts. The update did not change the current requirements for reporting net income or other comprehensive income and resulted in additional disclosure but had no significant effect on our condensed consolidated financial statements. The guidance was effective for reporting periods beginning after December 15, 2012 and was applied prospectively.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

In July 2013, the FASB issued *ASU 2013-10, Derivatives and Hedging (Topic 815), Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (a consensus of the FASB Emerging Issues Task Force).* Because we do not currently use hedge accounting for our derivative positions this addition to Topic 815 will not affect our financial statements.

Note 5 – Fair Value of Financial Instruments

Our valuation techniques for financial instruments are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from third-party sources, while unobservable inputs reflect management's market assumptions. The Accounting Standards Codification Topic No. 820 *"Fair Value Measurement"* classifies these inputs into the following hierarchy:

*Level 1 Input*s - Quoted prices for identical instruments in active markets.

Level 2 Inputs - Quoted prices for similar instruments 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 3 Inputs - Instruments with primarily unobservable value drivers.

The following describes the valuation methodologies used for our assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Cash - Cash and cash equivalents includes cash on deposit with financial institutions and investments in high quality overnight money market funds, all of which have maturities of three months or less, at the time of purchase. The carrying amount of cash is deemed to be its fair value. Our cash balances are classified as Level 1. Cash balances posted to or held by counterparties as collateral are classified as Level 2.

Agency Securities Available for Sale - Fair value for the Agency Securities in our securities portfolio is based on obtaining a valuation for each Agency Security from third-party pricing services and dealer quotes. The third-party pricing services use common market pricing methods that may include pricing models that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Agency Security is not available from the third-party pricing services or such data appears unreliable, we obtain valuations from up to three dealers who make markets in similar Agency Securities. In general, the dealers incorporate common market pricing methods, including a spread measurement to the Treasury curve or interest rate swap curve as well as underlying characteristics of the particular Agency Security including coupon, periodic and life caps, collateral type, rate reset period and seasoning or age of the Agency Security. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third-party pricing services, dealer quotes and comparisons to a third-party pricing model. Fair values obtained from the third-party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing methods used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third-party pricing service, but dealer quotes are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information received from dealers and classify it as a Level 3 security. At September 30, 2013 and December 31, 2012, all of our Agency Security fair values were based solely on third-party pricing services and dealer quotes and therefore were classified as Level 2.

Repurchase Agreements - The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at the estimated LIBOR based market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term to interest rate repricing, which may be at maturity, of our repurchase agreements. The fair value of the repurchase agreements approximates their carrying amount due to the short-term nature of these financial instruments. Our repurchase agreements are classified as Level 2.

Derivative Transactions - Our Futures Contracts are traded on the Chicago Mercantile Exchange (“CME”) and are classified as Level 1. The fair values of our interest rate swap contracts and interest rate swaptions are valued using third-party pricing services that incorporates common market pricing methods that may include current interest rate curves, forward interest rate curves and market spreads to interest rate curves. Management compares pricing used to dealer quotes to ensure that the current market conditions are properly reflected. The fair values of our interest rate swap contracts and our interest rate swaptions are classified as Level 2.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following tables provide a summary of our assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	**Significant Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Balance at September 30, 2013**
	(in thousands)			
Assets at Fair Value:				
Agency Securities, available for sale	$-	$16,664,917	$ -	$16,664,917
Derivatives	$-	$390,685	$ -	$390,685
Liabilities at Fair Value:				
Derivatives	$2,085	$107,932	$ -	$110,017

	Quoted Prices in Active Markets for Identical Assets	**Significant Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Balance at December 31, 2012**

	(Level 1) (in thousands)			
Assets at Fair Value:				
Agency Securities, available for sale	$-	$19,096,562	$ -	$19,096,562
Derivatives	$-	$5,367	$ -	$5,367
Liabilities at Fair Value:				
Derivatives	$3,919	$186,621	$ -	$190,540

The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed as of September 30, 2013 and December 31, 2012.

	At September 30, 2013		**Fair Value Measurements using:**		
	Carrying Value	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
	(in thousands)				
Financial Assets:					
Cash and cash equivalents	$496,480	$496,480	$496,480	$-	$ -
Cash collateral posted	$30,962	$30,962	$-	$30,962	$ -
Principal payments receivable	$256	$256	$-	$256	$ -
Accrued interest receivable	$45,985	$45,985	$-	$45,985	$ -
Financial Liabilities:					
Repurchase agreements	$14,917,525	$14,917,525	$-	$14,917,525	$ -
Cash collateral held	$294,071	$294,071	$-	$294,071	$ -
Payable for unsettled purchases	$143,894	$143,894	$-	$143,894	$ -
Accrued interest payable	$7,816	$7,816	$-	$7,816	$ -

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	At December 31, 2012		**Fair Value Measurements using:**		
	Carrying Value	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
	(in thousands)				
Financial Assets:					
Cash and cash equivalents	$771,282	$771,282	$771,282	$-	$ -
Cash collateral posted	$265,552	$265,552	$-	$265,552	$ -
Receivable for unsettled sales	$668,244	$668,244	$-	$668,244	$ -
Principal payments receivable	$16,037	$16,037	$-	$16,037	$ -
Accrued interest receivable	$55,430	$55,430	$-	$55,430	$ -
Financial Liabilities:					
Repurchase agreements	$18,366,095	$18,366,095	$-	$18,366,095	$ -
Accrued interest payable	$10,064	$10,064	$-	$10,064	$ -

Note 6 – Agency Securities, Available for Sale

All of our Agency Securities are classified as available for sale and, as such, are reported at their estimated fair value. As of September 30, 2013 and December 31, 2012, investments in Agency Securities accounted for 100% of our securities portfolio.

As of September 30, 2013, we had the following securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities as of September 30, 2013 are also presented below.

September 30, 2013	Fannie Mae	Freddie Mac	Ginnie Mae	Total Agency Securities
	(in thousands)			
Principal amount	$11,696,494	$4,548,910	$178,783	$16,424,187
Net unamortized premium	582,561	240,297	8,726	831,584
Amortized cost	12,279,055	4,789,207	187,509	17,255,771
Unrealized gains	18,018	5,862	1,449	25,329
Unrealized losses	(485,877)	(130,242)	(64)	(616,183)
Fair value	$11,811,196	$4,664,827	$188,894	$16,664,917

September 30, 2013	Adjustable and Hybrid Adjustable Rate	Fixed Rate	Total Agency Securities
	(in thousands)		
Principal amount	$257,609	$16,166,578	$16,424,187
Net unamortized premium	12,155	819,429	831,584
Amortized cost	269,764	16,986,007	17,255,771
Unrealized gains	3,164	22,165	25,329
Unrealized losses	(136)	(616,047)	(616,183)
Fair value	$272,792	$16,392,125	$16,664,917

We apply trade date accounting. Included in the above tables are unsettled purchases with an aggregate cost of $126.0 million and estimated fair value of $126.8 million at September 30, 2013.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

As of December 31, 2012, we had the following securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities as of December 31, 2012 are also presented below.

December 31, 2012	Fannie Mae	Freddie Mac	Ginnie Mae	Total Agency Securities
	(in thousands)			
Principal amount	$12,328,493	$5,305,071	$292,434	$17,925,998
Net unamortized premium	641,833	284,739	13,428	940,000
Amortized cost	12,970,326	5,589,810	305,862	18,865,998
Unrealized gains	169,227	66,904	6,466	242,597
Unrealized losses	(9,815)	(2,170)	(48)	(12,033)
Fair value	$13,129,738	$5,654,544	$312,280	$19,096,562

December 31, 2012	Adjustable and Hybrid Adjustable Rate	Fixed Rate	Total Agency Securities
	(in thousands)		
Principal amount	$2,037,778	$15,888,220	$17,925,998
Net unamortized premium	84,255	855,745	940,000
Amortized cost	2,122,033	16,743,965	18,865,998
Unrealized gains	36,758	205,839	242,597
Unrealized losses	(222)	(11,811)	(12,033)
Fair value	$2,158,569	$16,937,993	$19,096,562

We apply trade date accounting. We did not have unsettled purchases at December 31, 2012.

Actual maturities of Agency Securities are generally shorter than stated contractual maturities because actual maturities of Agency Securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal and prepayments of principal.

The following table summarizes the weighted average lives of our Agency Securities as of September 30, 2013 and December 31, 2012.

	September 30, 2013 (in thousands)		**December 31, 2012**	
Weighted Average Life of all Agency Securities	**Fair Value**	**Amortized Cost**	**Fair Value**	**Amortized Cost**
Less than one year	$4	$4	$2,647	$2,593
Greater than or equal to one year and less than three years	344,888	341,420	8,618,862	8,476,157
Greater than or equal to three years and less than five years	4,526,780	4,556,479	9,681,538	9,592,001
Greater than or equal to five years	11,793,245	12,357,868	793,515	795,247
Total Agency Securities	$16,664,917	$17,255,771	$19,096,562	$18,865,998

We use a third-party model to calculate the weighted average lives of our Agency Securities. Weighted average life is calculated based on expectations for estimated prepayments for the underlying mortgage loans of our Agency Securities. These estimated prepayments are based on assumptions such as interest rates, current and future home prices, housing policy and borrower incentives. The weighted average lives of our Agency Securities as of September 30, 2013 and December 31, 2012 in the table above are based upon market factors, assumptions, models and estimates from the third-party model and also incorporate management's judgment and experience. The actual weighted average lives of our Agency Securities could be longer or shorter than estimated.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table presents the unrealized losses and estimated fair value of our Agency Securities by length of time that such securities have been in a continuous unrealized loss position as of September 30, 2013 and December 31, 2012.

Unrealized Loss Position For:

(in thousands)

	Less than 12 Months		**12 Months or More**		**Total**	
As of	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
September 30, 2013	$13,726,984	$(588,648)	$340,219	$(27,535)	$14,067,203	$(616,183)
December 31, 2012	$1,521,052	$(12,030)	$836	$(3)	$1,521,888	$(12,033)

We evaluated our Agency Securities with unrealized losses and determined that there was no other than temporary impairments as of September 30, 2013 or December 31, 2012. As of those dates, we did not intend to sell Agency Securities and believed it was more likely than not that we could meet our liquidity requirements and contractual obligations without selling Agency Securities. The decline in value of these Agency Securities is solely due to market conditions and not the credit quality of the assets. All of our Agency Securities are issued and guaranteed by the GSEs. The GSEs have a rating of AA+.

During the quarter and nine months ended September 30, 2013, we sold $6.0 billion and $11.0 billion of Agency Securities resulting in realized losses of $301.0 million and $261.6 million, respectively. During the quarter and nine months ended September 30, 2012, we sold $1.6 billion and $1.9 billion of Agency Securities resulting in realized gains of $15.1 million and $20.1 million, respectively. Of the $20.1 million gain, $1.1 million is due to the bankruptcy of a counterparty to a repurchase agreement. In addition, due to the bankruptcy we also recorded $1.0 million of other income resulting from the non-performance of the counterparty on the related repurchase agreement.

Note 7 – Repurchase Agreements

The following table represents the contractual repricing regarding our repurchase agreements to finance Agency Security purchases as of September 30, 2013 and December 31, 2012.

	September 30, 2013	December 31, 2012
	(in thousands)	
Within 30 days	$4,561,783	$7,771,444
31 days to 60 days	8,641,962	7,840,268
61 days to 90 days	1,713,780	2,699,706
Greater than 90 days	-	54,677
Total	$14,917,525	$18,366,095

The following table represents the Master Repurchase Agreements ("MRAs") and other information regarding our repurchase agreements to finance Agency Security purchases as of September 30, 2013 and December 31, 2012.

	September 30, 2013	December 31, 2012
Number of MRAs	34	33
Number of counterparties with repurchase agreements outstanding	26	26
Weighted average maturity in days	39	34
Weighted average contractual rate	0.40 %	0.49 %
Haircut for repurchase agreements (1)	5.0 %	4.8 %

(1) The Haircut represents the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

For the nine months ended September 30, 2013, we sold short $2.8 billion of U.S Treasury Securities acquired under reverse repurchase agreements. We had purchases of $1.8 billion and $2.8 billion, respectively, of U.S. Treasury Securities resulting in a gain of $35.3 million and $14.2 million, respectively, for the quarter and nine months ended September 30, 2013. During the quarter ended September 30, 2013 we did not sell any U.S. Treasury Securities. During the quarter and nine months ended September 30, 2012, we did not sell or purchase any U.S. Treasury Securities.

Note 8 – Derivatives

We enter into transactions to manage our interest rate risk exposure. These transactions include entering into interest rate swap contracts and interest rate swaptions as well as purchasing or selling Futures Contracts. These transactions are designed to lock in funding costs for repurchase agreements associated with our assets in such a way to help assure the realization of net interest margins. Such transactions are based on assumptions about prepayments which, if not realized, will cause transaction results to differ from expectations. Our derivatives are carried on our condensed consolidated balance sheets, as assets or as liabilities at their fair value. We do not designate our derivatives as cash flow hedges and as such, we recognize changes in the fair value of these derivatives through earnings.

We have agreements with our swap (including swaption) counterparties that provide for the posting of collateral based on the fair values of our interest rate swap contracts. Through this margin process, either we or our swap counterparty may be required to pledge cash or Agency Securities as collateral. Collateral requirements vary by counterparty and change over time based on the market value, notional amount and remaining term of the contracts. Certain interest rate swap contracts provide for cross collateralization and cross default with repurchase agreements and other contracts with the same counterparty.

Interest rate swaptions generally provide us the option to enter into an interest rate swap agreement at a certain point of time in the future with a predetermined notional amount, stated term and stated rate of interest in the fixed leg and interest rate index on the floating leg.

Our Futures Contracts are traded on the CME which requires the use of daily mark-to-market collateral and the CME provides substantial credit support. The collateral requirements of the CME require us to pledge assets under a bi-lateral margin arrangement, including either cash or Agency Securities and these requirements may vary and change over time based on the market value, notional amount and remaining term of the Futures Contracts. In the event we are unable to meet a margin call under one of our Futures Contracts, the counterparty to such agreement may have the option to terminate or close-out all of the outstanding Futures Contracts with us. In addition, any close-out amount due to the counterparty upon termination of the counterparty's transactions would be immediately payable by us pursuant to the applicable agreement.

The following tables present information about interest rate swap contracts, interest rate swaptions and Futures Contracts which are included in derivatives on the accompanying condensed consolidated balance sheets as of September 30, 2013 and December 31, 2012.

September 30, 2013

	Notional Amount	**Assets at Fair Value (1)**	**Liabilities at Fair Value (1)**
	(in thousands)		
Interest rate swap contracts	$11,770,000	$327,174	$(107,932)
Interest rate swaptions	2,300,000	63,511	-
Futures Contracts	74,000	-	(2,085)
Totals	$14,144,000	$390,685	$(110,017)

(1) See Note 5, *"Fair Value of Financial Instruments"* for additional discussion.

We apply trade date accounting. Included in the above tables are unsettled purchases of interest rate swaptions with an aggregate cost of $16.6 million and estimated fair value of $15.3 million at September 30, 2013. Also included in payable for unsettled purchases on our condensed consolidated balance sheets is a payable for accrued interest on unsettled interest rate swap contracts sales of $1.3 million.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

December 31, 2012

	Notional Amount	Assets at Fair Value (1)	Liabilities at Fair Value (1)
	(in thousands)		
Interest rate swap contracts	$8,670,000	$1,718	$(186,621)
Interest rate swaptions	1,050,000	3,649	-
Futures Contracts	102,000	-	(3,919)
Totals	$9,822,000	$5,367	$(190,540)

(1) See Note 5, *"Fair Value of Financial Instruments"* for additional discussion.

We apply trade date accounting. We did not have unsettled purchases or sales at December 31, 2012.

The following tables present information about interest rate swap contracts, interest rate swaptions and Futures Contracts and the potential effects of netting if we were to offset the assets and liabilities of these financial instruments on the accompanying condensed consolidated balance sheets. Currently we present these financial instruments at their gross amounts and they are included in derivatives, at fair value on the accompanying condensed consolidated balance sheets as of September 30, 2013.

September 30, 2013

		Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet		
Assets	**Gross Amounts of Assets**	**Financial Instruments**	**Cash Collateral**	**Net Amount**

	Presented in the Condensed Consolidated Balance Sheet (in thousands)		Held (1)	
Interest rate swap contracts	$327,174	$(107,932)	$(204,651)	$14,591
Interest rate swaptions	63,511	-	-	63,511
Totals	$390,685	$(107,932)	$(204,651)	$78,102

(1) This is net of $28,144 of cash collateral posted and $232,795 of cash collateral held.

Liabilities	**Gross Amounts of Liabilities Presented in the Condensed Consolidated Balance Sheet (in thousands)**	**Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet**		**Net Amount**
		Financial Instruments	**Cash Collateral Posted**	
Interest rate swap contracts	$(107,932)	$107,932	$ -	$ -
Futures Contracts	(2,085)	-	2,200	115
Totals	$(110,017)	$107,932	$ 2,200	$ 115

19

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following tables present information about interest rate swap contracts, interest rate swaptions and Futures Contracts and the potential effects of netting if we were to offset the assets and liabilities of these financial instruments on the accompanying condensed consolidated balance sheets. Currently we present these financial instruments at their gross amounts and they are included in derivatives, at fair value on the accompanying condensed consolidated balance sheets as of December 31, 2012.

December 31, 2012

		Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet		
Assets	**Gross Amounts of Assets Presented in the Condensed Consolidated Balance Sheet**	**Financial Instruments**	**Cash Collateral Held**	**Net Amount**
	(in thousands)			
Interest rate swap contracts	$1,718	$(1,718)	$ -	$ -
Swaptions	3,649	-	-	3,649
Totals	$5,367	$(1,718)	$ -	$ 3,649

Gross Amounts Not Offset in the Condensed Consolidated

Liabilities	Gross Amounts of Liabilities Presented in the Condensed Consolidated Balance Sheet (in thousands)	Balance Sheet Financial Instruments	Cash Collateral Posted	Net Amount
Interest rate swap contracts	$(186,621)	$1,718	$261,364	$76,461
Futures Contracts	(3,919)	-	4,188	269
Totals	$(190,540)	$1,718	$265,552	$76,730

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table represents the location and information regarding our derivatives which are included in Other Income (Loss) in the accompanying condensed consolidated statements of operations for the quarters and nine months ended September 30, 2013 and September 30, 2012.

		Income (Loss) Recognized (in thousands)			
		For the Quarters Ended		For the Nine Months Ended	
Derivatives	**Location on condensed consolidated statements of operations**	**September 30, 2013**	**September 30, 2012**	**September 30, 2013**	**September 30, 2012**
Interest rate swap contracts:					
Realized gain	Realized loss on derivatives	$380	$ -	$380	$ -
Interest income	Realized loss on derivatives	4,306	2,562	13,464	5,421
Interest expense	Realized loss on derivatives	(43,725)	(20,832)	(119,456)	(44,779)
Changes in fair value	Unrealized gain (loss) on derivatives	(5,257)	(25,153)	395,237	(66,831)
		(44,296)	(43,423)	289,625	(106,189)
Interest rate swaptions:					
Realized gain	Realized loss on derivatives	2,353	-	2,353	-
Changes in fair value	Unrealized gain (loss) on derivatives	(7,049)	(6,593)	19,591	(18,070)
		(4,696)	(6,593)	21,944	(18,070)
Futures Contracts:					
Realized loss	Realized loss on derivatives	(576)	(644)	(1,914)	(1,697)
Changes in fair value	Unrealized gain (loss) on derivatives	485	260	1,834	636
		(91)	(384)	(80)	(1,061)
Totals		$(49,083)	$ (50,400)	$311,489	$(125,320)

Note 9 – Commitments and Contingencies

Management Agreement with ARRM

As discussed in Note 14 "*Related Party Transactions,*" we are externally managed by ARRM pursuant to a management agreement, as amended and restated on June 18, 2012 (the "2012 Management Agreement"). The 2012 Management Agreement entitles ARRM to receive a management fee payable monthly in arrears. Currently, the monthly management fee is 1/12th of the sum of (a) 1.5% of gross equity raised up to $1 billion plus (b) 0.75% of gross equity raised in excess of $1 billion. The cost of repurchased stock reduces the amount of gross equity raised used to calculate the monthly management fee. As of September 30, 2013, the effective management fee was 1.016% based on gross equity raised. The ARRM monthly management fee is not calculated based on the performance of our assets. Accordingly, the payment of our monthly management fee may not decline in the event of a decline in our earnings and may cause us to incur losses. We are also obligated to reimburse certain expenses incurred by ARRM and its subsidiary. ARRM is further entitled to receive a termination fee from us under certain circumstances.

Indemnifications and Litigation

We enter into certain contracts that contain a variety of indemnifications, principally with ARRM and underwriters, against third-party claims for errors and omissions in connection with their services to us. We have not incurred any costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements, as well as the maximum amount attributable to past events, is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2013 and December 31, 2012.

We are not party to any pending, threatened or contemplated litigation.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 10 – Stock Based Compensation

We adopted the 2009 Stock Incentive Plan (the "Plan") to attract, retain and reward directors and other persons who provide services to us in the course of operations. The Plan authorizes the Board to grant awards including common stock, restricted shares of common stock ("Restricted Shares"), stock options, performance shares, performance units, stock appreciation rights and other equity and cash-based awards (collectively "Awards"), subject to terms as provided in the Plan.

On May 12, 2010, the Board allocated up to 250,000 shares to be available under the Plan. In considering such allocation, the Board considered the size of the Plan relative to our capital base and our current and potential future performance and capitalization. On July 18, 2011, our stockholders approved an amendment to the Plan to increase the number of shares issuable thereunder from 250,000 shares to 2,000,000 shares and the Plan was amended accordingly. During the nine months ended September 30, 2013, we awarded a total of 1,278,195 Restricted Shares to ARRM for its employees. Of these awards, 150,208 shares vesting in 2017 were awarded subject to stockholder approval by June 30, 2017 of an increase to the number of shares issuable under the Plan.

RSU transactions for the nine months ended September 30, 2013 are summarized below:

	September 30, 2013	
	Number of Awards	**Weighted Average Grant Date Fair Value per Award**
Unvested Awards Outstanding beginning of period	628,367	$ 7.28
Granted	1,127,987	$ 6.78
Vested	(318,692)	$ 7.16

Forfeited	(2,490)	$ 7.69
Unvested Awards Outstanding end of period	1,435,172	$ 6.95

As of September 30, 2013, there was approximately $7.5 million of unvested non-cash stock based compensation related to the Awards (based on the September 30, 2013 stock price of $4.20 per share), that we expect to recognize as an expense over the remaining average service period of 3.1 years.

Note 11 – Stockholders' Equity

Dividends

The following table presents our common stock dividend transactions for the nine months ended September 30, 2013.

Record Date	**Payment Date**	**Rate per common share**	**Aggregate amount paid to holders of record (in millions)**
January 15, 2013	January 30, 2013	$ 0.08	$ 24.8
February 15, 2013	February 27, 2013	$ 0.08	$ 24.8
March 15, 2013	March 27, 2013	$ 0.08	$ 30.2
April 15, 2013	April 29, 2013	$ 0.07	$ 26.3
May 15, 2013	May 30, 2013	$ 0.07	$ 26.3
June 14, 2013	June 27, 2013	$ 0.07	$ 26.1
July 15, 2013	July 30, 2013	$ 0.07	$ 26.1
August 15, 2013	August 29, 2013	$ 0.07	$ 26.1
September 16, 2013	September 27, 2013	$ 0.07	$ 26.1

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table presents our Series A Preferred Stock dividend transactions for the nine months ended September 30, 2013.

Record Date	Payment Date	Rate per Series A Preferred Share	Aggregate amount paid to holders of record (in millions)
January 15, 2013	January 28, 2013	$ 0.17	$ 0.3
February 15, 2013	February 26, 2013	$ 0.17	$ 0.4
March 15, 2013	March 26, 2013	$ 0.17	$ 0.4
April 15, 2013	April 29, 2013	$ 0.17	$ 0.4
May 15, 2013	May 27, 2013	$ 0.17	$ 0.4
June 14, 2013	June 27, 2013	$ 0.17	$ 0.4
July 15, 2013	July 29, 2013	$ 0.17	$ 0.4
August 15, 2013	August 27, 2013	$ 0.17	$ 0.4
September 15, 2013	September 27, 2013	$ 0.17	$ 0.4

The following table presents our Series B Preferred Stock dividend transactions for the nine months ended September 30, 2013.

Record Date	Payment Date	Rate per Series B Preferred Share	Aggregate amount paid to holders of record

			(in millions)
March 15, 2013	March 27, 2013	$ 0.25	$ 1.4
April 15, 2013	April 29, 2013	$ 0.16	$ 0.9
May 15, 2013	May 27, 2013	$ 0.16	$ 0.9
June 14, 2013	June 27, 2013	$ 0.16	$ 0.9
July 15, 2013	July 29, 2013	$ 0.16	$ 0.9
August 15, 2013	August 27, 2013	$ 0.16	$ 0.9
September 15, 2013	September 27, 2013	$ 0.16	$ 0.9

Equity Capital Raising Activities

The following table presents our equity transactions for the nine months ended September 30, 2013.

Transaction Type	**Completion Date**	**Number of Shares**	**Per Share price**	**Net Proceeds (in millions)**
Series A Preferred equity distribution agreements	January 2, 2013 through January 30, 2013	174,961	$25.51 (1)	$ 4.4
Common stock dividend reinvestment program	January 25, 2013 through September 27, 2013	55,537	$4.98 (1)	$ 0.1
Series B Preferred initial offering	February 12, 2013	5,650,000	$25.00	$ 136.6
Common stock follow-on public offering	February 20, 2013	65,000,000	$6.75	$ 438.4

(1) Weighted average price

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Common Stock repurchases

During May 2013, we repurchased 3,395,603 shares of our outstanding common stock under the Repurchase Program at a weighted average price of $5.94 per share for an aggregate of $20.3 million.

Note 12 – Net Income (Loss) per Common Share

The following table presents a reconciliation of net income (loss) and the shares used in calculating weighted average basic and diluted earnings per common share for the quarters and nine months ended September 30, 2013 and September 30, 2012.

	For the Quarters Ended		**For the Nine Months Ended**	
	September 30, 2013	**September 30, 2012**	**September 30, 2013**	**September 30, 2012**
	(in thousands)			
Net Income (loss)	$(229,943)	$ 54,942	$ 353,732	$ 106,561
Less: Preferred dividends	(3,905)	(804)	(10,308)	(964)
Net income (loss) available (related) to common stockholders	$(233,848)	$ 54,138	$ 343,424	$ 105,597
Weighted average common shares outstanding – basic	370,818	269,325	268,202	195,272
Add: Effect of dilutive non-vested restricted stock unit awards, assumed vested	1,438	685	1,434	1,015
Weighted average common shares outstanding – diluted	372,256	270,010	269,636	196,287

We have 32,500,000 warrants outstanding which are anti-dilutive as their exercise price exceeded the average stock price for the quarters and nine months ended September 30, 2013 and September 30, 2012.

Note 13 – Income Taxes

We have elected to be taxed as a REIT under the Code. We will generally not be subject to federal income tax to the extent that we distribute our taxable income to our stockholders and as long as we satisfy the ongoing REIT requirements under the Code including meeting certain asset, income and stock ownership tests.

The following table reconciles our GAAP net income to estimated REIT taxable income for the quarters and nine months ended September 30, 2013 and September 30, 2012.

	For the Quarters Ended		For the Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
	(in thousands)			
GAAP net income (loss)	$(229,943)	$ 54,942	$353,732	$ 106,561
Book to tax differences:				
Unrealized (gain) loss on derivatives	11,821	31,486	(416,662)	84,265
Net capital losses	225,676	-	247,393	-
Amortization of deferred hedging costs	(1,611)	-	(1,119)	-
Realized gain on derivatives	(2,157)	-	(2,157)	-
Other	(7)	12	8	64
Estimated taxable income	$3,779	$ 86,440	$181,195	$ 190,890

The aggregate tax basis of our assets and liabilities is greater than our total Stockholders' Equity at September 30, 2013 by approximately $278.5 million, or approximately $0.75 per common share (based on the 370,905,142 common shares then outstanding).

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

We are required and intend to timely distribute substantially all of our REIT taxable income in order to maintain our REIT status under the Code. Total dividend payments to stockholders were $82.2 million and $247.1 for the quarter and nine months ended September 30, 2013, respectively. Our estimated REIT taxable income available to pay dividends was $3.8 million and $181.2 million for the quarter and nine months ended September 30, 2013, respectively. We also carried forward from the year ended December 31, 2012, undistributed REIT taxable income of $10.4 million. Our REIT taxable income and dividend requirements are determined on an annual basis. Dividends in excess of REIT taxable income for the year (including taxable income carried forward from the previous year) will generally not be taxable to common stockholders.

We have elected to treat Enterprise as a taxable REIT subsidiary, which is a tax paying entity for income tax purposes and it is taxed separately from ARMOUR. Because Enterprise is inactive, its taxes are nominal.

Our management is responsible for determining whether tax positions taken by us are more likely than not to be sustained on their merits. We have no material unrecognized tax benefits or material uncertain tax positions.

Note 14 – Related Party Transactions

We are externally managed by ARRM pursuant to the 2012 Management Agreement. All of our executive officers are also employees of ARRM. ARRM manages our day-to-day operations, subject to the direction and oversight of the Board. The 2012 Management Agreement expires after an initial term of ten years on June 18, 2022 and is thereafter automatically renewed for an additional five-year term unless terminated under certain circumstances. Either party must provide 180 days prior written notice of any such termination.

Under the terms of the 2012 Management Agreement, ARRM is responsible for costs incident to the performance of its duties, such as compensation of its employees and various overhead expenses. ARRM is responsible for the following primary roles:

Advising us with respect to, arranging for and managing the acquisition, financing, management and disposition of, elements of our investment portfolio;
Evaluating the duration risk and prepayment risk within the investment portfolio and arranging borrowing and hedging strategies;
Coordinating capital raising activities;
Advising us on the formulation and implementation of operating strategies and policies, arranging for the acquisition of assets, monitoring the performance of those assets and providing administrative and managerial services in connection with our day-to-day operations; and
Providing executive and administrative personnel, office space and other appropriate services required in rendering management services to us.

In accordance with the 2012 Management Agreement, we incurred \$6.5 million and \$21.0 million, respectively in management fees for the quarter and nine months ended September 30, 2013 The \$6.5 million of management fee expense for the quarter ended September 30, 2013, reflects an adjustment to reclassify \$0.7 million of expense as compensation related to Restricted Shares awarded to ARRM for its employees previously classified as management fees. For the quarter and nine months ended September 30, 2012, we incurred \$5.6 million and \$13.4 million in management fees, respectively.

We are required to take actions as may be reasonably required to permit and enable ARRM to carry out its duties and obligations. We are also responsible for any costs and expenses that ARRM incurred solely on behalf of ARMOUR or its subsidiary other than the various overhead expenses specified in the terms of the 2012 Management Agreement. For the quarter and nine months ended September 30, 2013, we reimbursed ARRM \$0.4 million and \$1.2 million, respectively, for other expenses incurred on our behalf. We also reimbursed \$0.2 million and \$0.9 of compensation expense during the quarter and nine months ended September 30, 2013, respectively related to Restricted Shares for ARRM employees (see Note 10, *"Stock Based Compensation"* for additional discussion). For the quarter and nine months ended September 30, 2012, we did not reimburse ARRM for any expenses.

Pursuant to a Sub-Management Agreement between ARMOUR, ARRM and Staton Bell Blank Check LLC (the "Sub-Manager"), ARRM is responsible for the monthly payment of a sub-management fee to the Sub-Manager in an amount equal to 25% of the monthly management fee earned by ARRM, net of expenses. On November 6, 2014, the Sub-Manager has the option of terminating the Sub-Management Agreement. If the Sub-Management Agreement is terminated, we would be required to make a final payment to the Sub-Manager in the amount of 6.16 times the annualized rate of the sub-management fee for the prior three months. Thereafter, we will be entitled to receive the sub-management fee or, at the option of ARRM, reimbursement of the final payment by ARRM. The payments from ARRM to the Sub-Manager for the three months preceding September 30, 2013 totaled \$1.5 million.

ARMOUR Residential REIT, Inc. and Subsidiary

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 15 – Interest Rate Risk

Our primary market risk is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned and the interest expense incurred in connection with the liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of Agency Securities and our ability to realize gains from the sale of these assets. A decline in the value of the Agency Securities pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels.

Note 16 – Subsequent Events

On October 28, 2013, a cash dividend of $0.17 per outstanding share of Series A Preferred Stock, or $0.4 million in the aggregate, was paid to holders of record on October 15, 2013. We have also announced cash dividends of $0.17 per outstanding share of Series A Preferred Stock payable November 27, 2013 to holders of record on November 15, 2013 and payable December 27, 2013 to holders of record on December 15, 2013.

On October 28, 2013, a cash dividend of $0.16 per outstanding share of Series B Preferred Stock, or $0.9 million in the aggregate, was paid to holders of record on October 15, 2013. We have also announced cash dividends of $0.16 per outstanding share of Series B Preferred Stock payable November 27, 2013 to holders of record on November 15, 2013 and payable December 27, 2013 to holders of record on December 15, 2013.

On October 28, 2013, a cash dividend of $0.05 per outstanding common share, or $18.6 million in the aggregate, was paid to holders of record on October 15, 2013. We have also announced cash dividends of $0.05 per outstanding share of common stock payable November 27, 2013 to holders of record on November 15, 2013 and payable December 27, 2013 to holders of record on December 16, 2013.

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

The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and related notes included elsewhere in this report.

References to "we," "us," "our," "ARMOUR" or the "Company" are to ARMOUR Residential REIT, Inc. References to "ARRM" are to ARMOUR Residential Management LLC, a Delaware limited liability company.

Overview

We are a Maryland corporation formed to invest in and manage a leveraged portfolio of mortgage backed securities ("MBS") and mortgage loans. The securities we invest in are issued or guaranteed by a United States ("U.S.") Government-sponsored entity ("GSE"), such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), or guaranteed by the Government National Mortgage Administration (Ginnie Mae) (collectively, "Agency Securities"). Our securities portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by U.S. Government-sponsored entities ("Agency Debt"), U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust ("REIT"). Our charter permits us to invest in Agency Securities and Non-Agency Securities. As of September 30, 2013, Agency Securities account for 100% of our securities portfolio. It is expected that the percentage will continue to be 100% or close thereto.

We are externally managed by ARRM, pursuant to a management agreement amended and restated on June 18, 2012 (the "2012 Management Agreement"). ARRM is an investment advisor registered with the Securities and Exchange Commission ("SEC"). ARRM is also the external manager of JAVELIN Mortgage Investment Corp. ("JAVELIN"), a publicly traded REIT, which invests in and manages a leveraged portfolio of Agency Securities and Non-Agency Securities. Our executive officers also serve as the executive officers of JAVELIN.

We seek attractive long-term investment returns by investing our equity capital and borrowed funds in our targeted asset class of Agency Securities. We earn returns on the spread between the yield on our assets and our costs, including the interest cost of the funds we borrow, after giving effect to our hedges. We identify and acquire Agency Securities, finance our acquisitions with borrowings under a series of short-term repurchase agreements at the most competitive interest rates available to us and then cost-effectively hedge our interest rate and other risks based on our entire portfolio of assets, liabilities and derivatives and our management's view of the market. Successful implementation of this approach requires us to address interest rate risk, maintain adequate liquidity and effectively hedge interest rate risks. We believe that the residential mortgage market will undergo significant changes in the coming years as the role of GSEs, such as Fannie Mae and Freddie Mac, is dimi