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American Capital Agency Corp  
Form 10-Q  
November 07, 2011

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

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FORM 10-Q

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

For the quarterly period ended September 30, 2011

OR

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

Commission file number 001-34057

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AMERICAN CAPITAL AGENCY CORP.  
(Exact name of registrant as specified in its charter)

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|                                                                   |                                         |
|-------------------------------------------------------------------|-----------------------------------------|
| Delaware                                                          | 26-1701984                              |
| (State or Other Jurisdiction of<br>Incorporation or Organization) | (I.R.S. Employer<br>Identification No.) |
| 2 Bethesda Metro Center, 14th Floor                               |                                         |
| Bethesda, Maryland 20814                                          |                                         |
| (Address of principal executive offices)                          |                                         |
| (301) 968-9300                                                    |                                         |
| (Registrant's telephone number, including area code)              |                                         |

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Indicate by check mark whether the registrant (1) has filed all reports 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 earlier period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

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

|                         |                                     |                   |                          |
|-------------------------|-------------------------------------|-------------------|--------------------------|
| Large accelerated filer | <input checked="" type="checkbox"/> | Accelerated filer | <input type="checkbox"/> |
|-------------------------|-------------------------------------|-------------------|--------------------------|

|                       |                          |                                               |                           |                          |
|-----------------------|--------------------------|-----------------------------------------------|---------------------------|--------------------------|
| Non-accelerated filer | <input type="checkbox"/> | (Do not check if a smaller reporting company) | Smaller Reporting Company | <input type="checkbox"/> |
|-----------------------|--------------------------|-----------------------------------------------|---------------------------|--------------------------|

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

The number of shares of the issuer's common stock, \$0.01 par value, outstanding as of October 31, 2011 was 183,619,759



AMERICAN CAPITAL AGENCY CORP.  
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Signatures

## PART I.—FINANCIAL INFORMATION

## ITEM 1. Financial Statements

AMERICAN CAPITAL AGENCY CORP.  
CONSOLIDATED BALANCE SHEETS  
(in thousands, except per share data)

|                                                                                                                                       | September 30,<br>2011<br>(Unaudited) | December 31,<br>2010 |
|---------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------|----------------------|
| Assets:                                                                                                                               |                                      |                      |
| Agency securities, at fair value (including pledged securities of \$38,860,353 and \$12,270,909, respectively)                        | \$41,970,419                         | \$13,510,280         |
| U.S. Treasury securities, at fair value                                                                                               | 300,873                              | —                    |
| Cash and cash equivalents                                                                                                             | 984,393                              | 173,258              |
| Restricted cash                                                                                                                       | 375,207                              | 76,094               |
| Derivative assets, at fair value                                                                                                      | 54,532                               | 76,593               |
| Receivable for agency securities sold                                                                                                 | 2,698,121                            | 258,984              |
| Principal payments receivable                                                                                                         | 33,831                               | 75,524               |
| Receivable under reverse repurchase agreements                                                                                        | 473,800                              | 247,438              |
| Other assets                                                                                                                          | 148,253                              | 57,658               |
| Total assets                                                                                                                          | \$47,039,429                         | \$14,475,829         |
| Liabilities:                                                                                                                          |                                      |                      |
| Repurchase agreements                                                                                                                 | \$38,841,619                         | \$11,680,092         |
| Other debt                                                                                                                            | 56,864                               | 72,927               |
| Payable for agency securities purchased                                                                                               | 1,660,276                            | 727,374              |
| Derivative liabilities, at fair value                                                                                                 | 792,714                              | 78,590               |
| Dividend payable                                                                                                                      | 257,068                              | 90,798               |
| Obligation to return securities borrowed under reverse repurchase agreements, at fair value                                           | 473,247                              | 245,532              |
| Accounts payable and other accrued liabilities                                                                                        | 17,385                               | 8,452                |
| Total liabilities                                                                                                                     | 42,099,173                           | 12,903,765           |
| Stockholders' equity:                                                                                                                 |                                      |                      |
| Preferred stock, \$0.01 par value; 10,000 shares authorized, 0 shares issued and outstanding, respectively                            | —                                    | —                    |
| Common stock, \$0.01 par value; 300,000 and 150,000 shares authorized, 183,620 and 64,856 shares issued and outstanding, respectively | 1,836                                | 649                  |
| Additional paid-in capital                                                                                                            | 4,829,065                            | 1,561,908            |
| Retained earnings                                                                                                                     | 67,174                               | 78,116               |
| Accumulated other comprehensive income (loss)                                                                                         | 42,181                               | (68,609)             |
| Total stockholders' equity                                                                                                            | 4,940,256                            | 1,572,064            |
| Total liabilities and stockholders' equity                                                                                            | \$47,039,429                         | \$14,475,829         |
| See accompanying notes to consolidated financial statements.                                                                          |                                      |                      |

AMERICAN CAPITAL AGENCY CORP.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
AND COMPREHENSIVE INCOME

(Unaudited)

(in thousands, except per share data)

|                                                                            | For the three months ended<br>September 30, |            | For the nine months ended<br>September 30, |            |
|----------------------------------------------------------------------------|---------------------------------------------|------------|--------------------------------------------|------------|
|                                                                            | 2011                                        | 2010       | 2011                                       | 2010       |
| Interest income:                                                           |                                             |            |                                            |            |
| Interest income                                                            | \$326,754                                   | \$62,600   | \$755,975                                  | \$151,986  |
| Interest expense                                                           | 95,036                                      | 18,531     | 194,500                                    | 51,389     |
| Net interest income                                                        | 231,718                                     | 44,069     | 561,475                                    | 100,597    |
| Other income, net:                                                         |                                             |            |                                            |            |
| Gain on sale of agency securities, net                                     | 262,768                                     | 24,565     | 360,880                                    | 81,558     |
| Realized loss on periodic interest settlements of interest rate swaps, net | (1,773)                                     | ) —        | (1,773)                                    | ) —        |
| Other realized loss on derivative instruments and other securities, net    | (173,190)                                   | ) (736)    | ) (222,594)                                | ) (4,214)  |
| Unrealized loss on derivative instruments and other securities, net        | (46,543)                                    | ) (2,997)  | ) (85,623)                                 | ) (15,466) |
| Total other income, net                                                    | 41,262                                      | 20,832     | 50,890                                     | 61,878     |
| Expenses:                                                                  |                                             |            |                                            |            |
| Management fees                                                            | 15,634                                      | 2,697      | 36,511                                     | 6,795      |
| General and administrative expenses                                        | 5,845                                       | 1,926      | 12,988                                     | 5,394      |
| Total expenses                                                             | 21,479                                      | 4,623      | 49,499                                     | 12,189     |
| Income before tax                                                          | 251,501                                     | 60,278     | 562,866                                    | 150,286    |
| Excise tax                                                                 | 1,100                                       | 250        | 1,100                                      | 250        |
| Net income                                                                 | \$250,401                                   | \$60,028   | \$561,766                                  | \$150,036  |
| Net income per common share—basic and diluted                              | \$1.39                                      | \$1.69     | \$4.19                                     | \$4.97     |
| Weighted average number of common shares outstanding—basic and diluted     | 180,725                                     | 35,495     | 134,163                                    | 30,161     |
| Dividends declared per common share                                        | \$1.40                                      | \$1.40     | \$4.20                                     | \$4.20     |
| Comprehensive income:                                                      |                                             |            |                                            |            |
| Net income                                                                 | \$250,401                                   | \$60,028   | \$561,766                                  | \$150,036  |
| Other comprehensive income (loss):                                         |                                             |            |                                            |            |
| Unrealized gain on available-for-sale securities, net                      | 535,439                                     | 11,660     | 814,536                                    | 73,077     |
| Unrealized loss on derivative instruments, net                             | (512,208)                                   | ) (38,620) | ) (703,747)                                | ) (91,002) |
| Other comprehensive income (loss)                                          | 23,231                                      | (26,960)   | ) 110,789                                  | (17,925)   |
| Comprehensive income                                                       | \$273,632                                   | \$33,068   | \$672,555                                  | \$132,111  |

See accompanying notes to consolidated financial statements.

## AMERICAN CAPITAL AGENCY CORP.

## CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(in thousands)

|                                                           | Preferred Stock |        | Common Stock |         | Additional      | Retained  | Accumulated                       | Total       |
|-----------------------------------------------------------|-----------------|--------|--------------|---------|-----------------|-----------|-----------------------------------|-------------|
|                                                           | Shares          | Amount | Shares       | Amount  | Paid-in Capital | Earnings  | Other Comprehensive Income (Loss) |             |
| Balance, December 31, 2010                                | —               | \$ —   | 64,856       | \$649   | \$1,561,908     | \$78,116  | \$ (68,609 )                      | \$1,572,064 |
| Net income                                                | —               | —      | —            | —       | —               | 133,543   | —                                 | 133,543     |
| Other comprehensive income (loss):                        |                 |        |              |         |                 |           |                                   |             |
| Unrealized loss on available-for-sale securities, net     | —               | —      | —            | —       | —               | —         | (39,802 )                         | (39,802 )   |
| Unrealized gain on designated derivative instruments, net | —               | —      | —            | —       | —               | —         | 61,126                            | 61,126      |
| Issuance of common stock                                  | —               | —      | 63,964       | 639     | 1,752,173       | —         | —                                 | 1,752,812   |
| Issuance of restricted stock                              | —               | —      | 9            | —       | —               | —         | —                                 | —           |
| Stock-based compensation                                  | —               | —      | —            | —       | 38              | —         | —                                 | 38          |
| Common dividends declared                                 | —               | —      | —            | —       | —               | (135,280) | —                                 | (135,280 )  |
| Balance, March 31, 2011 (Unaudited)                       | —               | —      | 128,829      | 1,288   | 3,314,119       | 76,379    | (47,285 )                         | 3,344,501   |
| Net income                                                | —               | —      | —            | —       | —               | 177,822   | —                                 | 177,822     |
| Other comprehensive income (loss):                        |                 |        |              |         |                 |           |                                   |             |
| Unrealized gain on available-for-sale securities, net     | —               | —      | —            | —       | —               | —         | 318,899                           | 318,899     |
| Unrealized loss on derivative instruments, net            | —               | —      | —            | —       | —               | —         | (252,664 )                        | (252,664 )  |
| Issuance of common stock                                  | —               | —      | 49,680       | 497     | 1,367,907       | —         | —                                 | 1,368,404   |
| Stock-based compensation                                  | —               | —      | —            | —       | 44              | —         | —                                 | 44          |
| Common dividends declared                                 | —               | —      | —            | —       | —               | (180,360) | —                                 | (180,360 )  |
| Balance, June 30, 2011 (Unaudited)                        | —               | —      | 178,509      | 1,785   | 4,682,070       | 73,841    | 18,950                            | 4,776,646   |
| Net income                                                | —               | —      | —            | —       | —               | 250,401   | —                                 | 250,401     |
| Other comprehensive income (loss):                        |                 |        |              |         |                 |           |                                   |             |
| Unrealized gain on available-for-sale securities, net     | —               | —      | —            | —       | —               | —         | 535,439                           | 535,439     |
| Unrealized loss on derivative instruments, net            | —               | —      | —            | —       | —               | —         | (512,208 )                        | (512,208 )  |
| Issuance of common stock                                  | —               | —      | 5,108        | 51      | 146,949         | —         | —                                 | 147,000     |
| Issuance of restricted stock                              | —               | —      | 3            | —       | —               | —         | —                                 | —           |
| Stock-based compensation                                  | —               | —      | —            | —       | 46              | —         | —                                 | 46          |
| Common dividends declared                                 | —               | —      | —            | —       | —               | (257,068) | —                                 | (257,068 )  |
| Balance, September 30, 2011 (Unaudited)                   | —               | \$ —   | 183,620      | \$1,836 | \$4,829,065     | \$67,174  | \$ 42,181                         | \$4,940,256 |

See accompanying notes to consolidated financial statements.



AMERICAN CAPITAL AGENCY CORP.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)  
(in thousands)

|                                                                                   | For the nine months ended<br>September 30, |              |
|-----------------------------------------------------------------------------------|--------------------------------------------|--------------|
|                                                                                   | 2011                                       | 2010         |
| Operating activities:                                                             |                                            |              |
| Net income                                                                        | \$561,766                                  | \$150,036    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                            |              |
| Amortization of agency securities premiums and discounts, net                     | 239,508                                    | 65,953       |
| Amortization of interest rate swap termination fee                                | —                                          | 6,278        |
| Stock-based compensation                                                          | 128                                        | 68           |
| Gain on sale of agency securities, net                                            | (360,880)                                  | (81,558)     |
| Loss on derivative instruments and other securities, net                          | 309,990                                    | 19,680       |
| Increase in other assets                                                          | (90,595)                                   | (19,457)     |
| Increase (decrease) in accounts payable and other accrued liabilities             | 8,933                                      | (812)        |
| Net cash provided by operating activities                                         | 668,850                                    | 140,188      |
| Investing activities:                                                             |                                            |              |
| Purchases of agency securities                                                    | (56,422,788)                               | (12,301,251) |
| Proceeds from sale of agency securities                                           | 24,351,207                                 | 6,693,342    |
| Purchases of U.S. Treasury securities                                             | (4,058,828)                                | (465,149)    |
| Proceeds from sale of U.S. Treasury securities                                    | 3,791,498                                  | 466,775      |
| Proceeds from U.S. Treasury securities sold, not yet purchased                    | 12,053,954                                 | —            |
| Purchases of U.S. Treasury securities sold, not yet purchased                     | (11,918,676)                               | —            |
| Proceeds from reverse repurchase agreements                                       | 28,615,437                                 | —            |
| Payments made on reverse repurchase agreements                                    | (28,841,942)                               | —            |
| Net payments on other derivative instruments not designated as qualifying hedges  | (194,081)                                  | (14,092)     |
| Principal collections on agency securities                                        | 3,058,375                                  | 972,551      |
| Net cash used in investing activities                                             | (29,565,844)                               | (4,647,824)  |
| Financing activities:                                                             |                                            |              |
| Cash dividends paid                                                               | (406,438)                                  | (118,638)    |
| Increase in restricted cash                                                       | (299,113)                                  | (42,834)     |
| Proceeds from repurchase arrangements, net                                        | 27,161,527                                 | 4,127,565    |
| Proceeds from other debt                                                          | —                                          | 80,822       |
| Repayments on other debt                                                          | (16,063)                                   | —            |
| Net proceeds from common stock issuances                                          | 3,268,216                                  | 373,184      |
| Net cash provided by financing activities                                         | 29,708,129                                 | 4,420,099    |
| Net change in cash and cash equivalents                                           | 811,135                                    | (87,537)     |
| Cash and cash equivalents at beginning of period                                  | 173,258                                    | 202,803      |
| Cash and cash equivalents at end of period                                        | \$984,393                                  | \$115,266    |
| See accompanying notes to consolidated financial statements.                      |                                            |              |

AMERICAN CAPITAL AGENCY CORP.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Unaudited Interim Consolidated Financial Statements

The interim consolidated financial statements of American Capital Agency Corp. (referred throughout this report as the “Company”, “we”, “us” and “our”) are prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. 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 income and expenses during the reporting period. Actual results could differ from those estimates.

Our unaudited consolidated financial statements include the accounts of our wholly-owned subsidiary, American Capital Agency TRS, LLC, and variable interest entities for which the Company is the primary beneficiary. Significant intercompany accounts and transactions have been eliminated. In the opinion of management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation of financial statements for the interim period have been included. The current period’s results of operations are not necessarily indicative of results that ultimately may be achieved for the year.

Note 2. Organization

We were organized in Delaware on January 7, 2008, and commenced operations on May 20, 2008 following the completion of our initial public offering (“IPO”). Our common stock is traded on The NASDAQ Global Select Market under the symbol “AGNC”.

We have elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Code”). As such, we are required to distribute annually 90% of our taxable net income. As long as we qualify as a REIT, we will generally not be subject to U.S. federal or state corporate taxes on our taxable net income to the extent that we distribute all of our annual taxable net income to our stockholders. It is our intention to distribute 100% of our taxable income, after application of available tax attributes, within the limits prescribed by the Code, which may extend into the subsequent taxable year.

We are externally managed by American Capital AGNC Management, LLC (our “Manager”), an affiliate of American Capital, Ltd. (“American Capital”).

We earn income primarily from investing in residential mortgage pass-through securities and collateralized mortgage obligations (“CMOs”) on a leveraged basis. These investments consist of securities for which the principal and interest payments are guaranteed by government-sponsored entities (“GSEs”), such as the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), or by a U.S. Government agency, such as the Government National Mortgage Association (“Ginnie Mae”). We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio. Our principal objective is to preserve our net asset value (also referred to as stockholders' equity) while generating attractive risk-adjusted returns for distribution to our stockholders through regular quarterly dividends from the combination of our net interest income and net realized gains and losses on our investments and other hedging activities. Our net interest income consists of the spread between the interest income earned on our agency securities and the interest costs of our borrowings and derivatives accounted for as hedges for accounting purposes (refer to Note 3 regarding discontinuation of hedge accounting as of September 30, 2011). We fund our investments primarily through short-term borrowings structured as repurchase agreements.

Note 3. Summary of Significant Accounting Policies  
Investments in Agency Securities

Accounting Standards Codification (“ASC”) Topic 320, Investments—Debt and Equity Securities (“ASC 320”), requires that at the time of purchase, we designate a security as held-to-maturity, available-for-sale or trading, depending on our ability and intent to hold such security to maturity. Securities classified as trading and available-for-sale are reported at fair value, while securities classified as held-to-maturity are reported at amortized cost. We may, from time to time, sell any of our agency securities as part of our overall management of our investment portfolio. Accordingly, we typically designate our agency securities as available-for-sale. All securities classified as available-for-sale are reported at fair value, with unrealized gains and

losses reported in other comprehensive income (loss) (“OCI”), a component of stockholders’ equity. Upon the sale of a security, we determine the cost of the security and the amount of unrealized gains or losses to reclassify out of accumulated OCI into earnings based on the specific identification method.

Interest-only securities and inverse interest-only securities (collectively referred to as “interest-only securities”) represent our right to receive a specified proportion of the contractual interest flows of specific agency and CMO securities. Principal-only securities represent our right to receive the contractual principal flows of specific agency and CMO securities. Interest-only and principal-only securities are measured at fair value through earnings in unrealized gain (loss) on derivative instruments and other securities, net in our consolidated statements of operations and comprehensive income. Our investments in interest-only and principal-only securities are included in agency securities, at fair value on the accompanying consolidated balance sheets.

We estimate the fair value of our agency securities based on a market approach using Level 2 inputs from third-party pricing services and dealer quotes. The third-party pricing services use pricing models that incorporate such factors as coupons, primary and secondary mortgage rates, prepayment speeds, spread to the Treasury and interest rate swap curves, convexity, duration, periodic and life caps and credit enhancements. The dealer quotes incorporate common market pricing methods, including a spread measurement to the Treasury or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security.

We evaluate securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Based on the criteria in ASC 320, the determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. When an agency security is impaired, an OTTI is considered to have occurred if (i) we intend to sell the agency security (i.e. a decision has been made as the reporting date) or (ii) it is more likely than not that we will be required to sell the agency security before recovery of its amortized cost basis. If we intend to sell the security or if it is more likely than not that we will be required to sell the agency security before recovery of its amortized cost basis, the entire amount of the impairment loss, if any, is recognized in earnings as a realized loss and the cost basis of the security is adjusted to its fair value.

We did not recognize any OTTI charges on any of our agency securities for the nine months ended September 30, 2011 and 2010.

#### Interest Income

Interest income is accrued based on the outstanding principal amount of the agency securities and their contractual terms. Premiums and discounts associated with the purchase of agency securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method in accordance with ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs (“ASC 310-20”).

We estimate long-term prepayment speeds using a third-party service and market data. The third-party service estimates prepayment speeds using models that incorporate the forward yield curve, current mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors. We review the prepayment speeds estimated by the third-party service and compare the results to market consensus prepayment speeds, if available. We also consider historical prepayment speeds and current market conditions to validate the reasonableness of the prepayment speeds estimated by the third-party service and based on our Manager’s judgment we may make adjustments to their estimates. Actual and anticipated prepayment experience is reviewed quarterly and effective yields are recalculated when differences arise between the previously estimated future prepayments and the amounts actually received plus current anticipated future prepayments. If the actual and anticipated future prepayment experience differs from our prior estimate of prepayments, we are required to record an adjustment in the current period to the amortization or accretion of premiums and discounts for the cumulative difference in the effective yield through the reporting date.

In addition, pursuant to ASC 310-20, the yield on our adjustable rate securities assumes that the securities reset at a rate equal to the underlying index rate in effect as of the date we acquired the security plus the stated margin. Consequently, future reset rate assumptions incorporated in our asset yields may differ materially from future reset

rates implied by the forward yield curve and the actual reset rates ultimately achieved. Further, notwithstanding changes to our actual and projected constant prepayment rate (“CPR”) assumptions, the lower our reset rate assumption is pursuant to ASC 310-20 than the current fixed rate in effect, the greater the rate of premium amortization we will recognize over the initial fixed rate period.

Our adjustable rate portfolio was acquired for a premium above par value and most securities were acquired during a period of historically low index rates. Accordingly, the premium balance on our adjustable rate securities will generally be fully amortized prior to their first reset date, regardless of actual or forecasted prepayment speeds and changes in the underlying

index rates prior to actual reset. Adjustable rate securities acquired during a different interest rate environment may experience a different premium amortization pattern even as current index rates remain near their historical lows.

#### Derivative and other Hedging Instruments

We maintain a risk management strategy, under which we use a variety of strategies to hedge some of our exposure to interest rate risk. The objective of our risk management strategy is to reduce fluctuations in book value over a range of interest rate scenarios. In particular, we attempt to mitigate the risk of the cost of our variable rate liabilities increasing during a period of rising interest rates. The principal instruments that we use are interest rate swaps and options to enter into interest rate swaps ("interest rate swaptions"). We also purchase or sell to-be-announced forward contracts ("TBAs"), specified agency securities on a forward basis, U.S. Treasury securities and U.S. Treasury futures contracts, purchase or write put or call options on TBA securities and invest in other types of mortgage derivatives, such as interest-only securities, and synthetic total return swaps, such as the Markit IOS Synthetic Total Return Swap Index ("Markit IOS Index").

We account for derivative instruments in accordance with ASC Topic 815, Derivatives and Hedging ("ASC 815"). ASC 815 requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value. Hedging instruments that are not derivatives under ASC 815 are accounted for as securities in accordance with ASC 320.

The accounting for changes in the fair value of derivative instruments depends on whether we have designated them as hedging instruments and whether they qualify as part of a hedging relationship pursuant to ASC 815 and, if so, on our reason for holding them.

Derivatives that are intended to hedge exposure to variability in expected future cash flows are referred to as cash flow hedges. For derivatives designated in qualifying cash flow hedge relationships, the effective portion of the fair value adjustments is initially recorded in OCI (a component of stockholders' equity) and reclassified to income at the time that the hedged transactions affect earnings. The ineffective portion of the fair value adjustments is immediately recognized in unrealized gain (loss) on derivative instruments and other securities, net. When the underlying hedged transaction ceases to exist, any amounts that have been previously recorded in accumulated OCI would be reclassified to net income and all subsequent changes in the fair value of the instrument would be included in unrealized gain (loss) on derivative instruments and other securities, net for each period until the derivative instrument matures or is settled.

For example, in the case of interest rate swap agreements in designated qualifying cash flow hedge relationships ("designated interest rate swaps"), the effective portion of changes in the fair value of the designated interest rate swaps are recorded in OCI. Accumulated OCI is subsequently reclassified into earnings through interest expense as the underlying repurchase agreements (hedged transactions) incur interest. The ineffective portion of fair value adjustments of designated interest rate swaps primarily relates to timing mismatches between the monthly variable rate reset dates of the interest rate swaps and the term of the underlying repurchase agreements. The underlying hedged transactions are determined to cease to exist for designated interest rate swap agreements (or previously designated interest rate swaps discussed below), if the current (or anticipated) repurchase agreement balance is less than the current notional value of the interest rate swap agreements.

For derivatives not designated in hedging relationships under ASC 815, the fair value adjustments are recorded in unrealized gain (loss) on derivative instruments and other securities, net. Our net book value is the same irrespective of whether we designate a derivative as a qualifying cash flow hedge.

Derivatives in a gain position are reported as derivative assets at fair value and derivatives in a loss position are reported as derivative liabilities at fair value in our consolidated balance sheets. In our consolidated statements of cash flows, cash receipts and payments related to derivative instruments are classified according to the underlying nature or purpose of the derivative transaction, generally in the operating section for derivatives designated in hedging relationships and the investing section for derivatives not designated in hedging relationships.

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We attempt to minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties. In addition, we mark our net counterparty exposure to market on

a daily basis and adjust posted collateral (in either direction) as a result.

Interest rate swap agreements

We use interest rate swaps to hedge the variable cash flows associated with short-term borrowings made under our repurchase agreement facilities. Prior to the quarter ended September 30, 2011, we generally entered into such derivatives with the intention of qualifying for hedge accounting under ASC 815.

During the quarter ended September 30, 2011, we discontinued our election to account for interest rate swaps as designated cash flow hedges. In order for our interest rate swaps to qualify as cash flow hedges under ASC 815, the monthly reset dates of our interest rate swaps are required to align with the term of an underlying repurchase agreement. This alignment had the effect of limiting our ability to alter or extend the maturity of our repurchase agreements. To provide greater funding flexibility, we determined that it was not beneficial to always match the pricing dates of our swaps and repurchase agreements and, thus, elected to discontinue hedge accounting by a combination of not designating new interest rate swaps entered into as qualifying cash flow hedges and de-designating all of our remaining swap contracts on September 30, 2011.

Provided we continue to hold repurchase agreements in excess of the notional value of our de-designated swap contracts, the net deferred loss related to the discontinued hedges incurred prior to de-designation will continue to be reported in accumulated OCI and will be reclassified into earnings through interest expense on a straight-line basis over their remaining contractual term, similar to as if the interest rate swaps had not been de-designated. As of September 30, 2011, the net deferred loss related to these interest rate swaps was \$744.4 million and their weighted average remaining contractual term was 3.4 years. The net deferred loss expected to be reclassified from OCI into interest expense over the next twelve months is \$208.8 million. In addition, all subsequent changes in the fair value of interest rates swaps will be recognized in our consolidated statement of operations and comprehensive income in unrealized gain (loss) on derivative instruments and other securities, net. Further, starting October 1, 2011, the net interest paid or received on our de-designated interest rate swaps, less amounts reclassified from accumulated OCI into earnings through interest expense, will be recognized in realized gain (loss) on periodic interest settlements of interest rate swaps, net. The net interest paid or received on our un-designated interest rate swaps is currently recognized in our consolidated statement of operations and comprehensive income in realized gain (loss) on periodic interest settlements of interest rate swaps, net.

We estimate the fair value of interest rate swaps based on inputs from a third-party pricing model. The third-party pricing model incorporates such factors as the Treasury curve, LIBOR rates, and the pay rate on the interest rate swaps. We also incorporate both our own and our counterparties' nonperformance risk in estimating the fair value of our interest rate swap and swaption agreements. In considering the effect of nonperformance risk, we consider the impact of netting and credit enhancements, such as collateral postings and guarantees, and have concluded that our own and our counterparty risk is not significant to the overall valuation of these agreements.

#### Interest rate swaptions

We may purchase interest rate swaptions to help mitigate the potential impact of increases or decreases in interest rates on the performance of our investment portfolio (referred to as "convexity risk"). The interest rate swaptions provide us 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. The premium paid for interest rate swaptions is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in unrealized gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive income. If a swaption expires unexercised, the loss on the swaption would be equal to the premium paid. If we sell or exercise a swaption, the realized gain or loss on the swaption would be equal to the difference between the cash or the fair value of the underlying interest rate swap received and the premium paid.

We estimate the fair value of interest rate swaptions based on the fair value of the future interest rate swap that we have the option to enter into as well as the remaining length of time that we have to exercise the option.

#### TBA securities

A TBA security is a futures contract for the purchase or sale of agency securities at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific agency securities delivered into the contract upon the settlement date, published each month by the Securities Industry and Financial Markets Association, are not known at the time of the transaction. TBA securities are exempt from ASC 815 and are accounted for under ASC 320 if there is no other way to purchase or sell that security, if delivery of that security and settlement will occur within the shortest period possible for that type of security and if it is probable at inception and throughout

the term of the individual contract that physical delivery of the security will occur (referred to as the “regular-way” exception). Alternatively, we may designate the TBA security as a qualifying cash flow hedge under ASC 815 if the regular-way exception is not met and at the time of the purchase or sale of the security, and throughout the term of the individual contract, it is probable that the forecasted transaction will occur and the hedging relationship is expected to be highly effective. For TBA security contracts that we have entered into, we have generally not asserted that physical settlement is probable or that the forecasted transaction is probable of occurring and, therefore, we typically have not designated these forward commitments as hedging instruments. Realized and unrealized gains and losses associated with TBA contracts not subject to the regular-way exception or not designated as hedging instruments are recognized in our consolidated statement of operations and comprehensive income in other realized gain (loss) on derivative instruments

and other securities, net and unrealized gain (loss) on derivative instruments and other securities, net, respectively. We estimate the fair value of TBA securities based on similar methods used to value agency securities.

#### Put and call options on TBA securities

We may purchase put and call options on TBA securities to hedge against short-term changes in interest rates. Under a purchased put option, we have the right to sell to the counterparty a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. Under a purchased call option, we have the right to purchase from the counterparty a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. The premium paid for a put or call option is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the option that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the option is reported in gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive income. When a purchased put or call option expires unexercised, a realized loss is reported in our consolidated statement of operations and comprehensive income equal to the premium paid. When a purchased put or call option is exercised, a realized gain or loss is reported in our consolidated statement of operations and comprehensive income equal to the difference between the premium paid and the fair value of the exercised put or call option. In addition, a derivative asset is recorded in our consolidated balance sheet for the TBA security resulting from the put or call option exercise.

We may also write put and call options on TBA securities. Under a written put option, the counterparty has the right to sell us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. Under a written call option, the counterparty has the right to purchase from us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. The premium received from writing a put or call option is reported as a liability in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the option that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the option is reported in gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive income. When a written put or call option expires unexercised, a realized gain is reported in our consolidated statement of operations equal to the premium received. When we terminate a written put or call option, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the termination payment and the premium received. When a written put or call option is exercised, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the premium received and the fair value of the exercised put or call option. In addition, a derivative asset or liability is recorded in our consolidated balance sheet for the TBA security resulting from the put or call option exercise.

We estimate the fair value of put and call options on TBA securities based on the fair value of the underlying TBA security as well as the remaining length of time to exercise the option.

#### Forward commitments to purchase or sell specified agency securities

We may enter into a forward commitment to purchase or sell specified agency securities as a means of acquiring assets or as a hedge against short-term changes in interest rates. Contracts for the purchase or sale of specified agency securities are accounted for as derivatives if the delivery of the specified agency security and settlement extends beyond the shortest period possible for that type of security. We may designate the forward commitment as a qualifying cash flow hedge if at the time of the purchase or sale of the security, and throughout the term of the individual contract, it is probable that physical delivery of the security will occur. Realized and unrealized gains and losses associated with forward commitments not designated as hedging instruments are recognized in our consolidated statement of operations and comprehensive income in gain (loss) on derivative instruments and other securities, net. We estimate the fair value of forward commitments to purchase or sell specified agency securities based on similar methods used to value agency securities as well as the remaining length of time of the forward commitment.

#### U.S. Treasury securities

We may purchase or sell short U.S. Treasury securities and U.S. Treasury futures contracts to help mitigate the potential impact of changes in interest rates on the performance of our portfolio. We may borrow securities to cover

short sales of U.S. Treasury securities under reverse repurchase agreements. We account for these as securities borrowing transactions and recognize an obligation to return the borrowed securities at fair value on the balance sheet based on the value of the underlying borrowed securities as of the reporting date. Realized and unrealized gains and losses associated with purchases and short sales of U.S. Treasury securities are recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statements of operations and comprehensive income.

### Total return swaps

We may enter into total return swaps to obtain exposure to a security or market sector without owning such security or investing directly in that market sector. Total return swaps are agreements in which there is an exchange of cash flows whereby one party commits to make payments based on the total return (coupon plus the mark-to-market movement) of an underlying instrument or index in exchange for fixed or floating rate interest payments. To the extent the total return of the instrument or index underlying the transaction exceeds or falls short of the offsetting interest rate obligation, we will receive a payment from or make a payment to the counterparty.

The primary total return swap index in which we invest is the Markit IOS Index. Total return swaps based on the Markit IOS index are intended to synthetically replicate the performance of interest-only securities. We determine the fair value of our total return swaps based on published index prices. Realized and unrealized gains and losses associated with changes in market value of the underlying index and coupon interest are recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statements of operations and comprehensive income.

### Variable Interest Entities

ASC Topic 810, Consolidation (“ASC 810”), requires a qualitative assessment in determining the primary beneficiary of a variable interest entities (“VIEs”) and ongoing assessments of control over such entities as well as additional disclosures for entities that have variable interests in VIEs.

We may enter into transactions involving a CMO trust (e.g. a VIE) whereby we transfer agency securities to an investment bank in exchange for cash proceeds and at the same time enter into a commitment with the same investment bank to purchase to-be-issued securities collateralized by the agency securities transferred. We will consolidate a CMO trust (as it relates to the assets transferred or contributed by us and the related liabilities issued by the trust) if we are the CMO trust’s primary beneficiary; that is, if we have a variable interest (or combination of variable interests) that provides us with a controlling financial interest in the CMO trust. An entity is deemed to have a controlling financial interest if the entity has the power to direct the activities of a VIE that most significantly impacts the VIE’s economic performance and the obligation to absorb losses of or right to receive benefits from the VIE that could potentially be significant to the VIE. In determining if we have a controlling financial interest, we evaluate whether we share the power to control the selection of financial assets transferred to the CMO trust with an unrelated party. We may share power in the selection of assets for certain CMO trusts (i.e., both we and the unrelated party must consent to the transfer of such assets to the CMO trust); however, if our economic interest in the CMO trust is disproportionate to the shared power, we may be deemed to be the primary beneficiary.

### Recent Accounting Pronouncements

In April 2011, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2011-03, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements (“ASU 2011-03”), which is intended to improve the accounting for repurchase agreements by removing from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, as well as implementation guidance related to that criterion. ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011 and the guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. We do not believe the adoption of ASU 2011-03 will have a material impact on our consolidated financial statements.

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (“ASU 2011-04”), which largely aligns fair value measurement and disclosure requirements between International Financial Reporting Standards and US GAAP. For US GAAP, the update mainly represents clarifications to Topic 820 as well as some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. ASU 2011-04 clarifies that (i) the highest and best use concept only applies to non-financial assets, (ii) an instrument classified in shareholders’ equity should be measured from the perspective of a market participant holding that instrument as an asset and (iii) quantitative disclosure is required for unobservable inputs used in Level 3 measurements. ASU 2011-04 also changes the guidance in Topic 820 so that (i) the fair value

of a group of financial assets and financial liabilities with similar risk exposures may be measured on the basis of the entity's net risk exposure, (ii) premiums or discounts may be applied in a fair value measurement under certain circumstances, but blockage factors are not permitted, and (iii) additional Level 3 disclosures are required, including a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. We do not believe the adoption of ASU 2011-04 will have a material impact on our consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive

Income (“ASU 2011-05”), which is intended to make the presentation of items within OCI more prominent. ASU 2011-05 requires companies to present comprehensive income in either one continuous statement or two separate but consecutive financial statements. Upon the effectiveness of ASU 2011-05, companies will no longer be allowed to present OCI in the statement of stockholders’ equity. In addition, reclassification adjustments between OCI and net income must be presented separately on the face of the financial statements. The new guidance does not change the components of OCI or the calculation of earnings per share. ASU 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted and the amendments should be applied retrospectively. We do not believe the adoption of ASU 2011-05 will have a material impact on our consolidated financial statements.

#### Reclassifications

Certain prior period amounts in the consolidated financial statements have been reclassified to conform to the current period presentation.

#### Note 4. Agency Securities

The following tables summarize our investments in agency securities as of September 30, 2011 (dollars in thousands):

|                                                                                     | As of September 30, 2011 |              |            |              |
|-------------------------------------------------------------------------------------|--------------------------|--------------|------------|--------------|
|                                                                                     | Fannie Mae               | Freddie Mac  | Ginnie Mae | Total        |
| Available-for-sale securities:                                                      |                          |              |            |              |
| Agency securities, par                                                              | \$22,477,679             | \$16,695,524 | \$102,938  | \$39,276,141 |
| Unamortized discount                                                                | (914 )                   | (996 )       | —          | (1,910 )     |
| Unamortized premium                                                                 | 988,626                  | 709,012      | 3,743      | 1,701,381    |
| Amortized cost                                                                      | 23,465,391               | 17,403,540   | 106,681    | 40,975,612   |
| Gross unrealized gains                                                              | 466,275                  | 337,846      | 2,130      | 806,251      |
| Gross unrealized losses                                                             | (11,342 )                | (8,305 )     | (23 )      | (19,670 )    |
| Available-for-sale securities, at fair value                                        | 23,920,324               | 17,733,081   | 108,788    | 41,762,193   |
| Agency securities remeasured at fair value through earnings:                        |                          |              |            |              |
| Interest-only and principal-only securities, amortized cost <sup>(1)</sup>          | 157,011                  | 71,285       | —          | 228,296      |
| Gross unrealized gains                                                              | 4,542                    | 2,323        | —          | 6,865        |
| Gross unrealized losses                                                             | (14,086 )                | (12,849 )    | —          | (26,935 )    |
| Agency securities remeasured at fair value through earnings, at fair value          | 147,467                  | 60,759       | —          | 208,226      |
| Total agency securities, at fair value                                              | \$24,067,791             | \$17,793,840 | \$108,788  | \$41,970,419 |
| Weighted average coupon as of September 30, 2011 <sup>(2)</sup>                     | 4.38                     | % 4.31       | % 4.15     | % 4.35       |
| Weighted average yield as of September 30, 2011 <sup>(3)</sup>                      | 3.17                     | % 3.20       | % 2.17     | % 3.18       |
| Weighted average yield for the three months ended September 30, 2011 <sup>(3)</sup> | 3.14                     | % 3.12       | % 2.22     | % 3.14       |
| Weighted average yield for the nine months ended September 30, 2011 <sup>(3)</sup>  | 3.29                     | % 3.21       | % 2.12     | % 3.25       |

Interest-only securities represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance (“UPB” or “par value”) of specific CMO securities. Principal-only securities represent the right to receive contractual principal flows of the UPB of specific CMO securities. The UPB of our interest-only securities was \$1.3 billion and the weighted average contractual interest we are entitled to receive was 5.57% of this amount as of September 30, 2011. The UPB of our principal-only securities was \$43 million as of September 30, 2011.

(2)

The weighted average coupon includes the interest cash flows from our interest-only securities taken together with the interest cash flows from our fixed-rate, adjustable-rate and CMO securities as a percentage of the par value of our agency securities (excluding the UPB of our interest-only securities) as of September 30, 2011.

- Incorporates an average future constant prepayment rate assumption of 13% based on forward rates as of September 30, 2011 and an average reset rate for adjustable rate securities of 2.76%, which is equal to the average underlying index rate of 0.96% based on the current spot rate in effect as of the date we acquired the securities and an average margin of 1.80%.
- (3)
-

|                                             | As of September 30, 2011 |                             |                             |                |
|---------------------------------------------|--------------------------|-----------------------------|-----------------------------|----------------|
|                                             | Amortized<br>Cost        | Gross<br>Unrealized<br>Gain | Gross<br>Unrealized<br>Loss | Fair Value     |
| Fixed-Rate                                  | \$37,554,811             | \$741,800                   | \$(18,354                   | ) \$38,278,257 |
| Adjustable-Rate                             | 3,179,456                | 59,639                      | (1,316                      | ) 3,237,779    |
| CMO                                         | 241,345                  | 4,812                       | —                           | 246,157        |
| Interest-only and principal-only securities | 228,296                  | 6,865                       | (26,935                     | ) 208,226      |
| Total agency securities                     | \$41,203,908             | \$813,116                   | \$(46,605                   | ) \$41,970,419 |

The following tables summarize our investments in agency securities as of December 31, 2010 (dollars in thousands):

|                                                                            | As of December 31, 2010 |             |            |              |   |
|----------------------------------------------------------------------------|-------------------------|-------------|------------|--------------|---|
|                                                                            | Fannie Mae              | Freddie Mac | Ginnie Mae | Total        |   |
| Agency securities classified as available-for-sale:                        |                         |             |            |              |   |
| Agency securities, par                                                     | \$8,207,464             | \$4,599,712 | \$100,408  | \$12,907,584 |   |
| Unamortized discount                                                       | (930                    | ) (1,044    | ) —        | (1,974       | ) |
| Unamortized premium                                                        | 350,747                 | 220,465     | 4,670      | 575,882      |   |
| Amortized cost                                                             | 8,557,281               | 4,819,133   | 105,078    | 13,481,492   |   |
| Gross unrealized gains                                                     | 56,181                  | 11,929      | 384        | 68,494       |   |
| Gross unrealized losses                                                    | (53,893                 | ) (42,356   | ) (196     | ) (96,445    | ) |
| Available-for-sale securities, at fair value                               | 8,559,569               | 4,788,706   | 105,266    | 13,453,541   |   |
| Agency securities remeasured at fair value through earnings:               |                         |             |            |              |   |
| Interest-only securities, amortized cost <sup>(1)</sup>                    | 18,957                  | 33,447      | —          | 52,404       |   |
| Gross unrealized gains                                                     | 1,559                   | 3,356       | —          | 4,915        |   |
| Gross unrealized losses                                                    | (91                     | ) (489      | ) —        | (580         | ) |
| Agency securities remeasured at fair value through earnings, at fair value | 20,425                  | 36,314      | —          | 56,739       |   |
| Total agency securities, at fair value                                     | \$8,579,994             | \$4,825,020 | \$105,266  | \$13,510,280 |   |
| Weighted average coupon as of December 31, 2010 <sup>(2)</sup>             | 4.63                    | % 4.83      | % 4.37     | % 4.70       | % |
| Weighted average yield as of December 31, 2010 <sup>(3)</sup>              | 3.34                    | % 3.28      | % 2.14     | % 3.31       | % |
| Weighted average yield for the year ended December 31, 2010 <sup>(3)</sup> | 3.49                    | % 3.42      | % 2.22     | % 3.44       | % |

Interest-only securities represent the right to receive a specified portion of the contractual interest flows of the UPB (1) of specific CMO securities. The UPB of our interest-only securities was \$0.5 billion and the weighted average contractual interest we are entitled to receive was 4.95% of this amount as of December 31, 2010.

The weighted average coupon includes the interest cash flows from our interest-only securities taken together with (2) the interest cash flows from our fixed-rate, adjustable-rate and CMO securities as a percentage of the par value of our agency securities (excluding the UPB of our interest-only securities) as of December 31, 2010.

(3) Incorporates an average future constant prepayment rate assumption of 12% based on forward rates as of December 31, 2010 and an average reset rate for adjustable rate securities of 2.76%, which is equal to the average underlying index rate of 0.94% based on the current spot rate in effect as of the date we acquired the securities and an average margin of 1.82%.



|                          | As of December 31, 2010 |                             |                             |                |
|--------------------------|-------------------------|-----------------------------|-----------------------------|----------------|
|                          | Amortized<br>Cost       | Gross<br>Unrealized<br>Gain | Gross<br>Unrealized<br>Loss | Fair Value     |
| Fixed-Rate               | \$9,144,352             | \$39,844                    | \$(82,717)                  | ) \$9,101,479  |
| Adjustable-Rate          | 3,942,937               | 20,955                      | (13,728)                    | ) 3,950,164    |
| CMO                      | 394,203                 | 7,695                       | —                           | 401,898        |
| Interest-only securities | 52,404                  | 4,915                       | (580)                       | ) 56,739       |
| Total agency securities  | \$13,533,896            | \$73,409                    | \$(97,025)                  | ) \$13,510,280 |

Actual maturities of agency securities are generally shorter than the stated contractual maturities. Actual maturities are affected by the contractual lives of the underlying mortgages, periodic principal payments and principal prepayments. The following table summarizes our agency securities classified as available-for-sale as of September 30, 2011 and December 31, 2010, according to their estimated weighted average life classification (dollars in thousands):

|                                                                                                | As of September 30, 2011 |                   |                               | As of December 31, 2010 |                   |                               |   |
|------------------------------------------------------------------------------------------------|--------------------------|-------------------|-------------------------------|-------------------------|-------------------|-------------------------------|---|
| Estimated Weighted Average<br>Life of Agency Securities<br>Classified as<br>Available-for-Sale | Fair Value               | Amortized<br>Cost | Weighted<br>Average<br>Coupon | Fair Value              | Amortized<br>Cost | Weighted<br>Average<br>Coupon |   |
| Less than or equal to one year                                                                 | \$3,097                  | \$3,112           | 5.50 %                        | \$—                     | \$—               | —                             | % |
| Greater than one year and less<br>than or equal to three years                                 | 7,769,007                | 7,613,464         | 4.32 %                        | 133,123                 | 132,520           | 5.05                          | % |
| Greater than three years and<br>less than or equal to five years                               | 30,555,145               | 29,971,368        | 4.09 %                        | 3,841,282               | 3,821,992         | 4.92                          | % |
| Greater than five years                                                                        | 3,434,944                | 3,387,668         | 4.43 %                        | 9,479,136               | 9,526,980         | 4.31                          | % |
| Total                                                                                          | \$41,762,193             | \$40,975,612      | 4.16 %                        | \$13,453,541            | \$13,481,492      | 4.49                          | % |

The weighted average life of our interest-only securities was 2.8 and 6.2 years as of September 30, 2011 and December 31, 2010, respectively. The weighted average life of our principal-only securities was 2.4 years as of September 30, 2011. We did not have principal-only securities as of December 31, 2010.

The weighted average lives of the agency securities as of September 30, 2011 and December 31, 2010 incorporates anticipated future prepayment assumptions. As of September 30, 2011, our weighted average expected constant prepayment rate (“CPR”) over the remaining life of our aggregate investment portfolio is 13%. Our estimates differ materially for different types of securities and thus individual holdings have a wide range of projected CPRs. We estimate long-term prepayment assumptions for different securities using third-party services and market data. These third-party services estimate prepayment speeds using models that incorporate the forward yield curve, current mortgage rates, mortgage rates of the outstanding loans, loan age, volatility and other factors. We review the prepayment speeds estimated by the third-party services and compare the results to market consensus prepayment speeds, if available. We also consider historical prepayment speeds and current market conditions to validate reasonableness. As market conditions may change rapidly, we use our judgment in making adjustments for different securities. Various market participants could use materially different assumptions.

Our agency securities classified as available-for-sale are reported at fair value, with unrealized gains and losses excluded from earnings and reported in OCI, a component of stockholders’ equity. The following table summarizes changes in accumulated OCI for available-for-sale securities for the three and nine months ended September 30, 2011 and 2010 (in thousands):

| Agency Securities Classified as<br>Available-for-Sale | Beginning<br>OCI<br>Balance | Unrealized Gains<br>and (Losses), Net | Reversal of Prior<br>Period Unrealized<br>(Gains) and Losses,<br>Net on Realization | Ending OCI<br>Balance |
|-------------------------------------------------------|-----------------------------|---------------------------------------|-------------------------------------------------------------------------------------|-----------------------|
|-------------------------------------------------------|-----------------------------|---------------------------------------|-------------------------------------------------------------------------------------|-----------------------|

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|                                       |           |             |          |             |
|---------------------------------------|-----------|-------------|----------|-------------|
| Three months ended September 30, 2011 | \$251,151 | 801,694     | (266,264 | ) \$786,581 |
| Three months ended September 30, 2010 | \$97,435  | 37,461      | (25,800  | ) \$109,096 |
| Nine months ended September 30, 2011  | \$(27,950 | ) 1,178,365 | (363,834 | ) \$786,581 |
| Nine months ended September 30, 2010  | \$36,018  | 155,349     | (82,271  | ) \$109,096 |

The following table presents the gross unrealized loss and fair values of our available-for-sale agency securities by length of time that such securities have been in a continuous unrealized loss position as of September 30, 2011 and December 31, 2010 (in thousands):

| Agency Securities Classified as Available-for-Sale | Unrealized Loss Position For |                 |                      |                 |                      |                 |
|----------------------------------------------------|------------------------------|-----------------|----------------------|-----------------|----------------------|-----------------|
|                                                    | Less than 12 Months          |                 | 12 Months or More    |                 | Total                |                 |
|                                                    | Estimated Fair Value         | Unrealized Loss | Estimated Fair Value | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| September 30, 2011                                 | \$4,145,531                  | \$(19,670 )     | \$—                  | \$—             | \$4,145,531          | \$(19,670 )     |
| December 31, 2010                                  | \$7,498,384                  | \$(96,445 )     | \$—                  | \$—             | \$7,498,384          | \$(96,445 )     |

As of September 30, 2011, we did not intend to sell any of these agency securities and we believe it is not more likely than not we will be required to sell the agency securities before recovery of their amortized cost basis. The unrealized losses on these agency securities are not due to credit losses given the government-sponsored entity or government guarantees but are rather due to changes in interest rates and prepayment expectations.

#### Gains and Losses

The following table is a summary of our net gain from the sale of agency securities for the three and nine months ended September 30, 2011 and 2010 (in thousands):

|                                                     | Three Months Ended |                    | Nine Months Ended  |                    |
|-----------------------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                                     | September 30, 2011 | September 30, 2010 | September 30, 2011 | September 30, 2010 |
| Agency securities sold, at cost                     | \$(14,045,636 )    | \$(2,172,978 )     | \$(26,429,464 )    | \$(6,914,764 )     |
| Proceeds from agency securities sold <sup>(1)</sup> | 14,308,404         | 2,197,543          | 26,790,344         | 6,996,322          |
| Net gains on sale of agency securities              | \$262,768          | \$24,565           | \$360,880          | \$81,558           |
| Gross gains on sale of agency securities            | \$267,573          | \$26,333           | \$376,806          | \$87,714           |
| Gross losses on sale of agency securities           | (4,805 )           | (1,768 )           | (15,926 )          | (6,156 )           |
| Net gains on sale of agency securities              | \$262,768          | \$24,565           | \$360,880          | \$81,558           |

(1) Proceeds include cash received during the period, plus receivable for agency securities sold during the period as of period end.

For the three and nine months ended September 30, 2011, we recognized an unrealized loss of \$27.5 and \$24.4 million, respectively, and for the three and nine months ended September 30, 2010, we recognized an unrealized gain of \$0.9 and an unrealized loss of \$7.8 million, respectively, in unrealized loss on derivative instruments and other securities, net in our consolidated statements of operations and comprehensive income for the change in value of investments in interest-only and principal-only securities, net of prior period reversals. For the three and nine months ended September 30, 2011, we recognized a realized loss of \$3.5 and \$3.0 million, respectively, and for the three and nine months ended September 30, 2010, we recognized a realized loss of \$1.2 million and \$0.7 million, respectively, in gain on sale of agency securities, net, in our consolidated statements of operations and comprehensive income for the sales of interest-only and principal-only securities.

#### Pledged Assets

The following tables summarize our agency securities pledged as collateral under repurchase agreements, other debt, derivative agreements and prime broker agreements by type as of September 30, 2011 and December 31, 2010 (in thousands):

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|                                                                    | As of September 30, 2011 |              |            |              |
|--------------------------------------------------------------------|--------------------------|--------------|------------|--------------|
| Agency Securities Pledged <sup>(1)</sup>                           | Fannie Mae               | Freddie Mac  | Ginnie Mae | Total        |
| Under Repurchase Agreements                                        |                          |              |            |              |
| Fair value                                                         | \$23,676,914             | \$16,989,065 | \$103,948  | \$40,769,927 |
| Amortized cost                                                     | 23,181,446               | 16,666,601   | 101,949    | 39,949,996   |
| Accrued interest on pledged agency securities                      | 74,214                   | 54,597       | 340        | 129,151      |
| Under Other Debt Agreements                                        |                          |              |            |              |
| Fair value                                                         | 60,796                   | —            | —          | 60,796       |
| Amortized cost                                                     | 59,807                   | —            | —          | 59,807       |
| Accrued interest on pledged agency securities                      | 243                      | —            | —          | 243          |
| Under Derivative Agreements                                        |                          |              |            |              |
| Fair value                                                         | 324,818                  | 356,372      | —          | 681,190      |
| Amortized cost                                                     | 317,846                  | 349,302      | —          | 667,148      |
| Accrued interest on pledged agency securities                      | 1,085                    | 1,124        | —          | 2,209        |
| Under Prime Broker Agreements                                      |                          |              |            |              |
| Fair value                                                         | 32,636                   | 8,872        | 1,397      | 42,905       |
| Amortized cost                                                     | 31,896                   | 8,657        | 1,375      | 41,928       |
| Accrued interest on pledged agency securities                      | 113                      | 29           | 5          | 147          |
| Total Fair Value of Agency Securities Pledged and Accrued Interest | \$24,170,819             | \$17,410,059 | \$105,690  | \$41,686,568 |

(1) Agency securities pledged include pledged amounts of \$2.69 billion related to agency securities sold but not yet settled as of September 30, 2011.

|                                                                    | As of December 31, 2010 |             |            |              |
|--------------------------------------------------------------------|-------------------------|-------------|------------|--------------|
| Agency Securities Pledged <sup>(2)</sup>                           | Fannie Mae              | Freddie Mac | Ginnie Mae | Total        |
| Under Repurchase Agreements                                        |                         |             |            |              |
| Fair value                                                         | \$7,707,046             | \$4,554,541 | \$95,066   | \$12,356,653 |
| Amortized cost                                                     | 7,709,785               | 4,591,245   | 94,860     | 12,395,890   |
| Accrued interest on pledged agency securities                      | 27,589                  | 15,642      | 332        | 43,563       |
| Under Other Debt Agreements                                        |                         |             |            |              |
| Fair value                                                         | 77,906                  | —           | —          | 77,906       |
| Amortized cost                                                     | 77,460                  | —           | —          | 77,460       |
| Accrued interest on pledged agency securities                      | 325                     | —           | —          | 325          |
| Under Derivative Agreements                                        |                         |             |            |              |
| Fair value                                                         | 36,651                  | 30,306      | —          | 66,957       |
| Amortized cost                                                     | 36,343                  | 30,382      | —          | 66,725       |
| Accrued interest on pledged agency securities                      | 156                     | 118         | —          | 274          |
| Under Prime Broker Agreements                                      |                         |             |            |              |
| Fair value                                                         | 6,061                   | 5,997       | 2,032      | 14,090       |
| Amortized cost                                                     | 6,061                   | 6,061       | 2,024      | 14,146       |
| Accrued interest on pledged agency securities                      | 28                      | 21          | 8          | 57           |
| Total Fair Value of Agency Securities Pledged and Accrued Interest | \$7,855,762             | \$4,606,625 | \$97,438   | \$12,559,825 |

(2) Agency securities pledged include pledged amounts of \$244.7 million related to agency securities sold but not yet settled as of December 31, 2010.

The following table summarizes our agency securities pledged as collateral under repurchase agreements and other debt by remaining maturity as of September 30, 2011 and December 31, 2010 (dollars in thousands):

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| Remaining Maturity of Repurchase Agreements and Other Debt | As of September 30, 2011 <sup>(1)</sup> |                                             |                                               | As of December 31, 2010 <sup>(1)</sup>  |                                             |                                               |
|------------------------------------------------------------|-----------------------------------------|---------------------------------------------|-----------------------------------------------|-----------------------------------------|---------------------------------------------|-----------------------------------------------|
|                                                            | Fair Value of Pledged Agency Securities | Amortized Cost of Pledged Agency Securities | Accrued Interest on Pledged Agency Securities | Fair Value of Pledged Agency Securities | Amortized Cost of Pledged Agency Securities | Accrued Interest on Pledged Agency Securities |
| 30 days or less                                            | \$34,011,545                            | \$33,320,906                                | \$107,886                                     | \$9,909,121                             | \$9,943,239                                 | \$35,151                                      |
| 31 - 59 days                                               | 4,836,073                               | 4,744,354                                   | 15,313                                        | 2,525,438                               | 2,530,111                                   | 8,737                                         |
| 60 - 90 days                                               | 543,799                                 | 531,016                                     | 1,690                                         | —                                       | —                                           | —                                             |
| Greater than 90 days                                       | 1,439,306                               | 1,413,527                                   | 4,505                                         | —                                       | —                                           | —                                             |
| Total                                                      | \$40,830,723                            | \$40,009,803                                | \$129,394                                     | \$12,434,559                            | \$12,473,350                                | \$43,888                                      |

(1) Agency securities pledged include pledged amounts of \$2.69 billion and \$244.7 million related to agency securities sold but not yet settled as of September 30, 2011 and December 31, 2010, respectively

#### Securitizations

All of our CMO securities are backed by fixed or adjustable-rate agency securities and Fannie Mae or Freddie Mac guarantees the payment of interest and principal and acts as the trustee and administrator of their respective securitization trusts. Our involvement with the consolidated CMO trust described below is limited to the agency securities transferred to the trust by the investment bank and the CMO securities subsequently held by us.

Accordingly, we are not required to provide the beneficial interest holders of the CMO securities any financial or other support. Whether or not we were involved with the formation of the CMO or purchased the securities from third parties in separate transactions, our maximum exposure to loss related to our involvement with CMO trusts is the fair value of the CMO securities and interest-only securities held by us. As of September 30, 2011 and December 31, 2010, the fair value of all of our CMO securities, interest-only securities and principal-only securities, excluding the consolidated CMO trust discussed below, was \$454.4 million and \$458.6 million, respectively, or \$458.3 million and \$463.6 million, respectively, including the net asset value of the consolidated CMO trust discussed below.

During fiscal year 2010, we entered into a CMO transaction whereby we transferred agency securities with a cost basis of \$85.9 million to an investment bank in exchange for cash proceeds of \$80.8 million and at the same time entered into a commitment with the same investment bank to purchase a to-be-issued interest-only strip collateralized by the agency securities transferred for \$5.1 million. The investment bank contributed the transferred agency securities to a securitization trust held by Fannie Mae in exchange for CMO securities issued by the trust. Once the transferred agency securities were transferred to the securitization trust, Fannie Mae may only remove such securities upon certain events. Pursuant to the pre-existing commitment, the investment bank transferred to us the interest-only security issued by the trust. Our primary purpose for entering into this transaction was to eliminate the need to finance the principal class by transferring it to third parties, while still retaining the underlying economics of a financed transaction for the transferred securities, which we viewed as favorable. We concluded that we were the primary beneficiary of the CMO trust based on our disproportionate economic interest and, accordingly, we consolidated the CMO trust as it related to the agency securities transferred by us and the related liabilities issued by the trust. The effect of consolidating the CMO trust was that the interest-only security received was eliminated and we continued to recognize the assets transferred to the securitization trust in our total agency securities held and recorded a corresponding liability for the debt issued by the securitization trust, which is classified as other debt in our accompanying consolidated balance sheets. As of September 30, 2011, we recognized agency securities with a total fair value of \$60.8 million and a principal balance of \$57.5 million collateralized the remaining debt outstanding issued by the securitization trust of \$56.9 million. As of December 31, 2010, we recognized agency securities with a total fair value of \$77.9 million and a principal balance of \$73.5 million collateralized the remaining debt outstanding issued by the securitization trust of \$72.9 million. Such agency securities can only be used to settle this debt and the holder(s) of the debt issued by the securitization trust have no recourse to us. Further, there are no arrangements that could require us to provide financial support to this securitization trust. The consolidation did not materially impact

our accompanying consolidated statements of operations and comprehensive income and consolidated statements of cash flows.

Note 5. Repurchase Agreements and Other Debt

We pledge certain of our agency securities as collateral under repurchase arrangements with financial institutions, the terms and conditions of which are negotiated on a transaction-by-transaction basis. Interest rates on these borrowings are generally based on LIBOR plus or minus a margin and amounts available to be borrowed are dependent upon the fair value of the agency securities pledged as collateral, which fluctuates with changes in interest rates, type of security and liquidity conditions within the banking, mortgage finance and real estate industries. In response to declines in fair value of pledged

agency securities, lenders may require us to post additional collateral or pay down borrowings to re-establish agreed upon collateral requirements, referred to as margin calls. As of September 30, 2011 and December 31, 2010, we have met all margin call requirements. Due to their short-term nature, repurchase agreements are carried at cost, which approximates fair value.

The following table summarizes our borrowings under repurchase arrangements and weighted average interest rates classified by original maturities as of September 30, 2011 and December 31, 2010 (dollars in thousands):

| Original Maturity        | As of September 30, 2011 |                       |                                   | As of December 31, 2010 |                       |                                   |
|--------------------------|--------------------------|-----------------------|-----------------------------------|-------------------------|-----------------------|-----------------------------------|
|                          | Borrowings Outstanding   | Average Interest Rate | Weighted Average Days to Maturity | Borrowings Outstanding  | Average Interest Rate | Weighted Average Days to Maturity |
| 1 month or less          | \$18,946,631             | 0.27                  | % 12                              | \$3,306,175             | 0.32                  | % 12                              |
| 1-2 months               | 8,110,844                | 0.28                  | % 22                              | 5,648,155               | 0.31                  | % 20                              |
| 2-3 months               | 4,789,136                | 0.26                  | % 26                              | 1,496,452               | 0.29                  | % 33                              |
| 3-6 months               | 5,662,617                | 0.25                  | % 34                              | 1,229,310               | 0.29                  | % 43                              |
| 6-9 months               | 278,758                  | 0.41                  | % 215                             | —                       | —                     | % —                               |
| 9-12 months              | 1,053,633                | 0.50                  | % 348                             | —                       | —                     | % —                               |
| Total / Weighted Average | \$38,841,619             | 0.28                  | % 30                              | \$11,680,092            | 0.31                  | % 22                              |

As of September 30, 2011 and December 31, 2010, we did not have an amount at risk with any counterparty greater than 10% of our stockholders' equity. On October 31, 2011, MF Global Holdings, Ltd., an affiliate of MF Global Inc., a counterparty to one of our master repurchase agreements, filed for Chapter 11 in a U.S. bankruptcy court. As of October 31, 2011, we had less than \$1.0 million of counterparty exposure with regard to MF Global Inc.

Other debt of \$56.9 million and \$72.9 million as of September 30, 2011 and December 31, 2010, respectively, consists of other variable rate debt outstanding at LIBOR plus 25 basis points in connection with the consolidation of a structured transaction for which we are the primary beneficiary in our accompanying financial statements (see Note 4).

#### Note 6. Derivative and Other Hedging Instruments

In connection with our risk management strategy, we hedge a portion of our interest rate risk by entering into derivative and other hedging instrument contracts. We may enter into agreements for interest rate swap agreements, interest rate swaptions, interest rate cap or floor contracts and futures or forward contracts. We may also purchase or short TBA and U.S. Treasury securities, purchase or write put or call options on TBA securities or we may invest in other types of mortgage derivative securities, such as interest-only securities, and synthetic total return swaps, such as the IOS Index. Our risk management strategy attempts to manage the overall risk of the portfolio, reduce fluctuations in book value and generate additional income distributable to stockholders. For additional information regarding our derivative instruments and our overall risk management strategy, please refer to the discussion of derivative and other hedging instruments in Note 3.

As of September 30, 2011 and December 31, 2010, our derivative and other hedging instruments were comprised primarily of interest rate swaps, which have the effect of modifying the repricing characteristics of our repurchase agreements and cash flows on such liabilities. Our interest rate swaps are used to manage the interest rate risk created by our variable rate short-term repurchase agreements. Under our interest rate swaps, we typically pay a fixed-rate and receive a floating rate based on one-month LIBOR with terms up to 10 years, but generally up to 5 years or less. As discussed further in Note 3, prior to September 30, 2011, our interest rate swaps were typically designated as cash flow hedges under ASC 815.

Derivative and other hedging instruments entered into in addition to interest rate swap agreements are intended to supplement our use of interest rate swaps and we do not currently expect our use of these instruments to be the primary protection against interest rate risk for our portfolio. These instruments are accounted for as either derivatives, but are not generally designated as hedges under ASC 815, or as other securities, with any changes in the fair values

of the contracts prior to their settlement date included in earnings in unrealized gain (loss) on derivative instruments and other securities, net in our consolidated statements of operations and comprehensive income. We do not use derivative or other hedging instruments for speculative purposes.

**Derivatives Designated as Hedging Instruments**

Prior to September 30, 2011, we entered into interest rate swap agreements typically with the intention of qualifying for hedge accounting under ASC 815. However, during the quarter ended September 30, 2011, we elected to discontinue hedge accounting by a combination of not designating new interest rate swaps as qualifying cash flow hedges and de-designating all

of our remaining interest rate swaps on September 30, 2011 (see Note 3 for further information on our discontinuation of hedge accounting). As of December 31, 2010, we had net interest rate swap liabilities of \$37.7 million designated as qualifying cash flow hedges.

The tables below summarize information about our outstanding interest rate swaps designated as cash flow hedges as of September 30, 2011 and December 31, 2010 (dollars in thousands):

| Interest Rate Swaps Designated as Hedging Instruments | Balance Sheet Location                | As of September 30, 2011 | December 31, 2010 |
|-------------------------------------------------------|---------------------------------------|--------------------------|-------------------|
| Interest rate swap assets                             | Derivative assets, at fair value      | \$—                      | \$33,695          |
| Interest rate swap liabilities                        | Derivative liabilities, at fair value | —                        | (71,417 )         |
|                                                       |                                       | \$—                      | \$(37,722 )       |

|                                                                         | As of December 31, 2010 |                        |                      |                          |                          |
|-------------------------------------------------------------------------|-------------------------|------------------------|----------------------|--------------------------|--------------------------|
| Remaining Term of Interest Rate Swaps Designated as Hedging Instruments | Notional Amount         | Average Fixed Pay Rate | Average Receive Rate | Net Estimated Fair Value | Average Maturity (Years) |
| 1 year or less                                                          | \$750,000               | 1.40                   | % 0.26               | % \$(5,595 )             | 0.7                      |
| Greater than 1 year and less than 3 years                               | 2,850,000               | 1.54                   | % 0.26               | % (32,865 )              | 2.5                      |
| Greater than 3 years and less than 5 years                              | 2,850,000               | 1.78                   | % 0.26               | % 738                    | 4.3                      |
| Greater than 5 years                                                    | —                       | —                      | % —                  | % —                      | —                        |
| Total                                                                   | \$6,450,000             | 1.63                   | % 0.26               | % \$(37,722 )            | 3.1                      |

The following table summarizes information about our outstanding interest rate swaps designated as hedging instruments for the three and nine months ended September 30, 2011 and 2010 (in thousands):

| Interest Rate Swaps Designated as Hedging Instruments | Beginning Notional Amount | Additions  | Expirations/ Terminations | Hedge De-Designations | Ending Notional Amount |
|-------------------------------------------------------|---------------------------|------------|---------------------------|-----------------------|------------------------|
| Three months ended September 30, 2011                 | \$22,000,000              | 2,100,000  | (200,000 )                | (23,900,000 )         | \$—                    |
| Three months ended September 30, 2010                 | \$3,000,000               | 1,200,000  | —                         | —                     | \$4,200,000            |
| Nine months ended September 30, 2011                  | \$6,450,000               | 17,900,000 | (450,000 )                | (23,900,000 )         | \$—                    |
| Nine months ended September 30, 2010                  | \$2,050,000               | 2,150,000  | —                         | —                     | \$4,200,000            |

The table below summarizes the effect of interest rate swaps designated as hedges under ASC 815 on our consolidated statement of operations for the three and nine months ended September 30, 2011 and 2010 (in thousands):

| Interest Rate Swaps Designated as Hedging Instruments | Amount of Gain or (Loss) Recognized in OCI (Effective Portion) | Location of Gain or (Loss) Reclassified from OCI into Earnings (Effective Portion) | Amount of Gain or (Loss) Reclassified from OCI into Earnings (Effective Portion) | Location of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|-------------------------------------------------------|----------------------------------------------------------------|------------------------------------------------------------------------------------|----------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|
| Three months ended September 30, 2011                 | \$ (512,208 )                                                  | Interest Expense                                                                   | \$ (70,854 )                                                                     | Loss on derivative instruments and Other securities, net                                                               | \$ (914 )                                                                                                            |
| Three months ended September 30, 2010                 | \$ (39,823 )                                                   | Interest Expense                                                                   | \$ (13,261 )                                                                     | Loss on derivative instruments and Other securities, net                                                               | \$ (25 )                                                                                                             |
| Nine months ended September 30, 2011                  | \$ (706,972 )                                                  | Interest Expense                                                                   | \$ (140,074 )                                                                    | Loss on derivative instruments and Other securities, net                                                               | \$ (1,552 )                                                                                                          |
| Nine months ended September 30, 2010                  | \$ (99,428 )                                                   | Interest Expense                                                                   | \$ (40,332 )                                                                     | Loss on derivative instruments and Other securities, net                                                               | \$ (340 )                                                                                                            |

As of September 30, 2011, the amount of net deferred loss related to de-designated interest rate swaps was \$744.4 million, which, provided we continue to hold repurchase agreements in excess of the notional value of our de-designated swap contracts, will be reclassified from OCI into earnings through interest expense over a weighted average remaining contractual term of 3.4 years. The net deferred loss expected to be reclassified from OCI into interest expense over the next twelve months is \$208.8 million.

Additionally, during the nine months ended September 30, 2011 and the three and nine months ended September 30, 2010, we entered into or held forward contracts to purchase TBA and specified agency securities that were designated as cash flow hedges pursuant to ASC 815. We did not enter into such agreements during the three month period ended September 30, 2011. The following table summarizes information about our outstanding forward contracts designated as hedging instruments for the three and nine months ended September 30, 2011 and 2010 (dollars in thousands):

| Purchases of TBAs and Forward Settling Agency Securities Designated as Hedging Instruments | Beginning Notional Amount | Additions | Settlement / Expirations | Ending Notional Amount | Fair Value as of Period End | Average Maturity as of Period End (Months) |
|--------------------------------------------------------------------------------------------|---------------------------|-----------|--------------------------|------------------------|-----------------------------|--------------------------------------------|
| Three months ended September 30, 2011                                                      | \$—                       | —         | —                        | \$—                    | \$—                         | —                                          |
| Three months ended September 30, 2010                                                      | \$80,000                  | 175,000   | (80,000 )                | \$175,000              | \$1,807                     | 3                                          |
| Nine months ended September 30, 2011                                                       | \$245,000                 | —         | (245,000 )               | \$—                    | \$—                         | —                                          |
| Nine months ended September 30, 2010                                                       | \$—                       | 321,303   | (146,303 )               | \$175,000              | \$1,807                     | 3                                          |

The effective portion of gains or losses for TBAs and forward settling specified agency securities is initially recognized in OCI for designated cash flow hedges and is subsequently reclassified within OCI for available-for-sale securities upon acquisition of the underlying hedged item. The ineffective portion of gains or losses is recognized in earnings in realized gain (loss) on derivative instruments and other securities, net.

The table below summarizes the effect of purchases of TBAs and forward settling securities designated as hedges under ASC 815 on our consolidated statement of operations and comprehensive income for the three and nine months ended September 30, 2011 and 2010 (in thousands).

| Purchases of TBAs and Forward Settling Agency Securities Designated as Hedging Instruments | Amount of Gain or (Loss) Recognized in OCI for Cash Flow Hedges (Effective Portion) | Amount of Gain or (Loss) Recognized in OCI for Cash Flow Hedges and Reclassified to OCI for Available-for-Sale Securities (Effective Portion) | Location of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Gain or (Loss) Recognized in Earnings (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|--------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|
| Three months ended September 30, 2011                                                      | \$ —                                                                                | \$ —                                                                                                                                          | Loss on derivative instruments and Other securities, net                                                               | \$ —                                                                                                                 |
| Three months ended September 30, 2010                                                      | \$ 1,807                                                                            | \$ —                                                                                                                                          | Loss on derivative instruments and Other securities, net                                                               | \$ —                                                                                                                 |
| Nine months ended September 30, 2011                                                       | \$ 12                                                                               | \$ (3,213)                                                                                                                                    | Loss on derivative instruments and Other securities, net                                                               | \$ —                                                                                                                 |
| Nine months ended September 30, 2010                                                       | \$ 1,807                                                                            | \$ 1,262                                                                                                                                      | Loss on derivative instruments and Other securities, net                                                               | \$ —                                                                                                                 |

#### Derivatives Not Designated as Hedging Instruments

As of September 30, 2011 and December 31, 2010, we had interest rate swap agreements outstanding that were not designated as hedges under ASC 815 consisting of interest rate swap agreements where we pay a fixed rate ("payer interest rate swaps") and interest rate swap agreements where we receive a fixed rate ("receiver interest rate swaps"), summarized in the tables below (dollars in thousands).

| Maturity of Interest Rate Swaps Not Designated as Hedging Instruments <sup>(1)</sup> | As of September 30, 2011 |                        |                      |                          |                          |
|--------------------------------------------------------------------------------------|--------------------------|------------------------|----------------------|--------------------------|--------------------------|
|                                                                                      | Notional Amount          | Average Fixed Pay Rate | Average Receive Rate | Net Estimated Fair Value | Average Maturity (Years) |
| 2011                                                                                 | \$ 300,000               | 1.28                   | % 0.23               | % \$(652)                | ) 0.1                    |
| 2012                                                                                 | 750,000                  | 2.01                   | % 0.23               | % (10,898)               | ) 0.9                    |
| 2013                                                                                 | 3,050,000                | 1.06                   | % 0.23               | % (34,534)               | ) 1.8                    |
| 2014                                                                                 | 7,300,000                | 1.22                   | % 0.24               | % (127,255)              | ) 2.8                    |
| 2015                                                                                 | 7,700,000                | 1.51                   | % 0.28               | % (193,141)              | ) 3.7                    |
| 2016                                                                                 | 7,550,000                | 2.17                   | % 0.23               | % (392,090)              | ) 4.7                    |
| 2018                                                                                 | 100,000                  | 1.79                   | % 0.37               | % (486)                  | ) 7.1                    |
| 2021                                                                                 | 200,000                  | 2.00                   | % 0.37               | % 1,460                  | 10.1                     |
| Total Payer Interest Rate Swaps                                                      | \$ 26,950,000            | 1.58                   | % 0.25               | % \$(757,596)            | ) 3.4                    |

(1) Amounts include the effect of deferred start dates for forward starting swaps of \$1.9 billion ranging from one to three months from September 30, 2011.

| Interest Rate Swaps Not | As of December 31, 2010 |          |         |         |     |
|-------------------------|-------------------------|----------|---------|---------|-----|
|                         | Maturity                | Notional | Average | Average | Net |

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| Designated as Hedging Instruments |      | Amount    | Fixed Pay<br>(Receive)<br>Rate | Receive<br>(Pay)<br>Rate | Estimated<br>Fair Value | Maturity<br>(Years) |
|-----------------------------------|------|-----------|--------------------------------|--------------------------|-------------------------|---------------------|
| Payer interest rate swaps         | 2015 | \$250,000 | 1.66                           | % 0.26                   | % \$4,140               | 4.9                 |
| Receiver interest rate swaps      | 2015 | \$200,000 | (2.26                          | )% (0.26                 | )% \$2,743              | 4.7                 |

As of September 30, 2011 and December 31, 2010, we had interest rate swaption agreements outstanding consisting of options to enter into interest rate swaps in the future where we would pay a fixed rate (“payer swaptions”) as summarized in the tables below (dollars in thousands).

| Payer Swaptions          | Option   |               | Average<br>Months to<br>Expiration | Underlying Swap    |             |                            |                            |
|--------------------------|----------|---------------|------------------------------------|--------------------|-------------|----------------------------|----------------------------|
|                          | Cost     | Fair<br>Value |                                    | Notional<br>Amount | Pay<br>Rate | Average<br>Receive<br>Rate | Average<br>Term<br>(Years) |
| As of September 30, 2011 | \$45,570 | \$4,456       | 8                                  | \$3,250,000        | 3.59 %      | 1M LIBOR                   | 6.9                        |
| As of December 31, 2010  | \$4,596  | \$16,766      | 4                                  | \$850,000          | 2.28 %      | 1M LIBOR                   | 5.6                        |

As of September 30, 2011 and December 31, 2010, we had contracts to purchase (“long position”) and sell (“short position”) TBA and specified agency securities on a forward basis. Following is a summary of our long and short TBA and forward settling positions as of September 30, 2011 and December 31, 2010 (in thousands).

|                                                                                                                  | As of September 30, 2011 |               | As of December 31, 2010 |            |
|------------------------------------------------------------------------------------------------------------------|--------------------------|---------------|-------------------------|------------|
| Purchase and Sale Contracts for TBAs and<br>Forward Settling<br>Securities Not Designated as Hedging Instruments | Notional Amount          | Fair<br>Value | Notional Amount         | Fair Value |
| TBA securities:                                                                                                  |                          |               |                         |            |
| Purchase contracts                                                                                               | \$5,426,400              | \$21,471      | \$2,282,000             | \$13,510   |
| Sale contracts                                                                                                   | (5,994,000 )             | (10,464 )     | (3,290,200 )            | 3,611      |
| TBA securities, net <sup>(1)</sup>                                                                               | (567,600 )               | 11,007        | (1,008,200 )            | 17,121     |
| Forward settling securities:                                                                                     |                          |               |                         |            |
| Purchase contracts                                                                                               | 10,000                   | (44 )         | 159,303                 | (1,820 )   |
| Sale contracts                                                                                                   | (259,615 )               | (1,695 )      | —                       | —          |
| Forward settling securities, net <sup>(2)</sup>                                                                  | (249,615 )               | (1,739 )      | 159,303                 | (1,820 )   |
| Total TBA and forward settling securities, net                                                                   | \$(817,215 )             | \$9,268       | \$(848,897 )            | \$15,301   |

(1)Includes 15-year and 30-year TBA securities of varying coupons

(2)Includes 20-year fixed securities and ARMs of varying coupons

As of September 30, 2011, we had total return swaps outstanding linked to the Markit IOS Index, summarized in the table below. Under these swap agreements, we are either entitled to receive (“long position”) or pay (“short position”) a stated coupon linked to the index, net of an implied financing cost equal to one-month LIBOR, plus/(minus) increases/(decreases) in the index market value. Long positions are intended to synthetically replicate the performance of interest-only securities. Therefore, as interest rates rise and prepayment expectations decline, the index will typically increase in value and, as interest rates fall and prepayment expectations rise, the index will typically decrease in value. The holder of a long position is required to pay a monthly periodic cash settlement equal to a decrease in the index value and, conversely, is entitled to receive a periodic cash settlement equal to an increase in the index value. The converse applies to the holder of a short position. Changes, or mark-to-market movements, in the index are measured from the preceding periodic measurement date. Periodic cash settlements of the index mark-to-market movements are netted against periodic cash settlements of the stated coupon, less the implied financing costs.

As of September 30, 2011, the linked index values of our total return swaps totaled \$(40.6) million. The net fair value of these total return swaps reported in derivative assets and liabilities on our consolidated balance sheet as of September 30, 2011 was \$4.0 million and represents the unrealized mark-to-market change in the linked index value since the preceding measurement date through September 30, 2011. Realized and unrealized gains and losses associated with changes in the underlying linked index value and net coupon interest are recognized in gain (loss) on derivative instruments and other securities, net in our consolidated statements of operations and comprehensive income. We did not have any total return swaps outstanding as of December 31, 2010.



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| (in thousands) |                                                 | As of September 30, 2011 |                 |            |
|----------------|-------------------------------------------------|--------------------------|-----------------|------------|
| Position       | Markit IOS Sub-Index                            | Notional Amount          | Expiration Date | Fair Value |
| Long           | 6.0%, 30-Year, Fixed Rate, Fannie Mae MBS Pools | \$64,595                 | January 2039    | \$(1,079 ) |
| Short          | 5.0%, 30-Year, Fixed Rate, Fannie Mae MBS Pools | (158,462 )               | January 2040    | 1,835      |
|                | 5.5%, 30-Year, Fixed Rate, Fannie Mae MBS Pools | (49,764 )                | January 2039    | 1,310      |
|                | 6.0%, 30-Year, Fixed Rate, Fannie Mae MBS Pools | (114,674 )               | January 2039    | 1,916      |
| Total Short    |                                                 | (322,900 )               |                 | 5,061      |
| Net            |                                                 | \$(258,305 )             |                 | \$3,982    |

The table below summarizes fair value information about our derivatives outstanding that were not designated as hedging instruments as of September 30, 2011 and December 31, 2010 (in thousands).

| Derivatives Not Designated as Hedging Instruments      | Balance Sheet Location                | As of              |                   |
|--------------------------------------------------------|---------------------------------------|--------------------|-------------------|
|                                                        |                                       | September 30, 2011 | December 31, 2010 |
| Purchase of TBA and forward settling agency securities | Derivative assets, at fair value      | \$24,469           | \$2,929           |
| Sale of TBA and forward settling agency securities     | Derivative assets, at fair value      | 7,794              | 16,320            |
| U.S. Treasury futures                                  | Derivative assets, at fair value      | 1,708              | —                 |
| Markit IOS total return swaps - short                  | Derivative assets, at fair value      | 5,061              | —                 |
| Payer interest rate swaps                              | Derivative assets, at fair value      | 4,608              | 4,140             |
| Receiver interest rate swaps                           | Derivative assets, at fair value      | 6,436              | 2,743             |
| Payer swaptions                                        | Derivative assets, at fair value      | 4,456              | 16,766            |
|                                                        |                                       | \$54,532           | \$42,898          |
| Purchase of TBA and forward settling agency securities | Derivative liabilities, at fair value | \$(3,042 )         | \$(2,193 )        |
| Sale of TBA and forward settling agency securities     | Derivative liabilities, at fair value | (19,953 )          | (1,755 )          |
| Payer interest rate swaps                              | Derivative liabilities, at fair value | (768,640 )         | —                 |
| Markit IOS total return swaps - long                   | Derivative liabilities, at fair value | (1,079 )           | —                 |
|                                                        |                                       | \$(792,714 )       | \$(3,948 )        |

Additionally, as of September 30, 2011 and December 31, 2010, we had obligations to return treasury securities borrowed under reverse repurchase agreements accounted for as securities borrowing transactions for a fair value of \$473.2 million and \$245.5 million, respectively. The borrowed securities were used to cover short sales of treasury securities from which we received total proceeds of \$468.4 million and \$244.8 million, respectively. The change in fair value of the borrowed securities is recorded in gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive income.

The tables below summarize the effect of derivative instruments not designated as hedges under ASC 815 on our consolidated statement of operations and comprehensive income for the three and nine months ended September 30, 2011 and 2010 (in thousands):



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For the Three Months Ended September 30, 2011

| Derivatives Not Designated as Hedging Instruments      | Notional Amount as of June 30, 2011 | Additions  | Additions Due to Hedge De-Designations | Settlement, Expiration or Exercise | Notional Amount as of September 30, 2011 | Amount of Gain/(Loss) Recognized in Income on Derivatives <sup>(1)</sup> |
|--------------------------------------------------------|-------------------------------------|------------|----------------------------------------|------------------------------------|------------------------------------------|--------------------------------------------------------------------------|
| Purchase of TBA and forward settling agency securities | \$3,432,365                         | 19,881,039 | —                                      | (17,877,004)                       | \$5,436,400                              | \$ 73,335                                                                |
| Sale of TBA and forward settling agency securities     | \$4,281,525                         | 37,866,575 | —                                      | (35,894,485)                       | \$6,253,615                              | (146,363 )                                                               |
| Payer interest rate swaps                              | \$250,000                           | 2,900,000  | 23,900,000                             | —                                  | \$27,050,000                             | (6,243 )                                                                 |
| Receiver interest rate swaps                           | \$100,000                           | —          | —                                      | —                                  | \$100,000                                | 3,365                                                                    |
| Payer swaptions                                        | \$4,050,000                         | 250,000    | —                                      | (1,050,000 )                       | \$3,250,000                              | (32,734 )                                                                |
| Short sales of U.S. Treasury securities                | \$1,464,000                         | 3,450,000  | —                                      | (4,449,000 )                       | \$465,000                                | (92,018 )                                                                |
| U.S. Treasury futures                                  | \$—                                 | 350,000    | —                                      | —                                  | \$350,000                                | 1,702                                                                    |
| Markit IOS total return swaps - long                   | \$682,655                           | 64,595     | —                                      | (682,655 )                         | \$64,595                                 | (18,817 )                                                                |
| Markit IOS total return swaps - short                  | \$309,303                           | 322,900    | —                                      | (309,303 )                         | \$322,900                                | 19,665                                                                   |
|                                                        |                                     |            |                                        |                                    |                                          | \$ (198,108 )                                                            |

This amount excludes \$27.5 million recorded as a loss for interest-only and principal-only securities re-measured at fair value through earnings, a loss of \$0.9 million for hedge ineffectiveness on our outstanding interest rate swaps (1) designated as hedging instruments and a net gain of \$5.0 million from other derivatives and securities in gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive income for the three months ended September 30, 2011.

For the Three Months Ended September 30, 2010

| Derivatives Not Designated as Hedging Instruments      | Notional Amount as of June 30, 2010 | Additions | Settlement, Expiration or Exercise | Notional Amount as of September 30, 2010 | Amount of Gain/(Loss) Recognized in Income on Derivatives <sup>(2)</sup> |
|--------------------------------------------------------|-------------------------------------|-----------|------------------------------------|------------------------------------------|--------------------------------------------------------------------------|
| Purchase of TBA and forward settling agency securities | \$181,142                           | 947,794   | (760,018 )                         | \$ 369,098                               | \$2,296                                                                  |
| Sale of TBA and forward settling agency securities     | \$270,000                           | 2,005,073 | (1,351,912 )                       | \$ 923,161                               | (10,059 )                                                                |
| Payer interest rate swaps                              | \$—                                 | 200,000   | (150,000 )                         | \$ 50,000                                | (2,303 )                                                                 |
| Receiver interest rate swaps                           | \$—                                 | 200,000   | —                                  | \$ 200,000                               | 88                                                                       |
| Payer swaptions                                        | \$200,000                           | —         | —                                  | \$ 200,000                               | (7 )                                                                     |
| Receiver swaptions                                     | \$300,000                           | —         | (300,000 )                         | \$ —                                     | 7,004                                                                    |
| Short sales of U.S. Treasury securities                | \$—                                 | 150,000   | (150,000 )                         | \$ —                                     | (330 )                                                                   |
|                                                        |                                     |           |                                    |                                          | \$ (3,311 )                                                              |

(2) This amount excludes \$0.9 million recorded as a loss for interest-only securities re-measured at fair value through earnings, a loss of \$25 thousand for hedge ineffectiveness on our outstanding interest rate swaps and a gain of \$0.5

million from other securities in gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive income for the three months ended September 30, 2010.

## For the Nine Months Ended September 30, 2011

| Derivatives Not Designated as Hedging Instruments      | Notional Amount as of December 31, 2010 | Additions  | Additions Due to Hedge De-Designations | Settlement, Expiration or Exercise | Notional Amount as of September 30, 2011 | Amount of Gain/(Loss) Recognized in Income on Derivatives <sup>(3)</sup> |
|--------------------------------------------------------|-----------------------------------------|------------|----------------------------------------|------------------------------------|------------------------------------------|--------------------------------------------------------------------------|
| Purchase of TBA and forward settling agency securities | \$ 512,303                              | 42,222,204 | —                                      | (37,298,107)                       | \$ 5,436,400                             | \$ 118,586                                                               |
| Sale of TBA and forward settling agency securities     | \$ 1,361,200                            | 88,795,265 | —                                      | (83,902,850)                       | \$ 6,253,615                             | (292,699 )                                                               |
| Put options                                            | \$—                                     | (200,000 ) | —                                      | 200,000                            | \$ —                                     | 1,133                                                                    |
| Payer interest rate swaps                              | \$ 250,000                              | 2,900,000  | 23,900,000                             | —                                  | \$ 27,050,000                            | (12,130 )                                                                |
| Receiver interest rate swaps                           | \$ 200,000                              | —          | —                                      | (100,000 )                         | \$ 100,000                               | 4,291                                                                    |
| Payer swaptions                                        | \$ 850,000                              | 4,450,000  | —                                      | (2,050,000 )                       | \$ 3,250,000                             | (58,614 )                                                                |
| Receiver swaptions                                     | \$—                                     | 250,000    | —                                      | (250,000 )                         | \$ —                                     | (736 )                                                                   |
| Short sales of U.S. Treasury securities                | \$ 250,000                              | 11,974,000 | —                                      | (11,759,000)                       | \$ 465,000                               | (91,823 )                                                                |
| Treasury futures                                       | \$—                                     | 400,000    | —                                      | (50,000 )                          | \$ 350,000                               | 1,950                                                                    |
| Markit IOS total return swaps - long                   | \$—                                     | 1,154,015  | —                                      | (1,089,420 )                       | \$ 64,595                                | (6,377 )                                                                 |
| Markit IOS total return swaps - short                  | \$—                                     | 635,559    | —                                      | (312,659 )                         | \$ 322,900                               | 19,120                                                                   |
|                                                        |                                         |            |                                        |                                    |                                          | \$ (317,299 )                                                            |

(3) This amount excludes \$24.4 million recorded as a loss for interest-only securities re-measured at fair value through earnings, a loss of \$1.6 million for hedge ineffectiveness on our outstanding interest rate swaps and a gain of \$33.3 million from other securities in gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive for the nine months ended September 30, 2011.

## For the Nine Months Ended September 30, 2010

| Derivatives Not Designated as Hedging Instruments      | Notional Amount as of December 31, 2009 | Additions | Settlement, Expiration or Exercise | Notional Amount as of September 30, 2010 | Amount of Gain/(Loss) Recognized in Income on Derivatives <sup>(4)</sup> |
|--------------------------------------------------------|-----------------------------------------|-----------|------------------------------------|------------------------------------------|--------------------------------------------------------------------------|
| Purchase of TBA and forward settling agency securities | \$ 596,516                              | 2,037,063 | (2,264,481 )                       | \$ 369,098                               | \$ 14,730                                                                |
| Sale of TBA and forward settling agency securities     | \$ 616,747                              | 4,822,333 | (4,515,919 )                       | \$ 923,161                               | (30,936 )                                                                |
| Put options                                            | \$—                                     | 75,000    | (75,000 )                          | \$—                                      | (328 )                                                                   |
| Payer interest rate swaps                              | \$—                                     | 350,000   | (300,000 )                         | \$ 50,000                                | (3,414 )                                                                 |
| Receiver interest rate swaps                           | \$—                                     | 200,000   | —                                  | \$ 200,000                               | 88                                                                       |
| Payer swaptions                                        | \$ 200,000                              | —         | —                                  | \$ 200,000                               | (2,389 )                                                                 |
| Receiver swaptions                                     | \$ 100,000                              | 300,000   | (400,000 )                         | \$—                                      | 9,130                                                                    |
| Short sales of U.S. Treasury securities                | \$—                                     | 150,000   | (150,000 )                         | \$—                                      | (330 )                                                                   |
|                                                        |                                         |           |                                    |                                          | \$ (13,449 )                                                             |

(4) This amount excludes \$7.8 million recorded as a loss for interest-only securities re-measured at fair value through earnings, a loss of \$0.3 million for hedge ineffectiveness on our outstanding interest rate swaps and a gain of \$1.9 million from other securities in gain (loss) on derivative instruments and other securities, net in our consolidated statement of operations and comprehensive for the nine months ended September 30, 2010.

**Credit Risk-Related Contingent Features**

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties. In addition, we may be required to pledge assets as collateral for our derivatives, whose amounts vary over time based on the market value, notional amount and remaining term of the derivative contract. In the event of a default by a counterparty we may not receive payments provided for under the terms of our derivative agreements, and may have difficulty obtaining our assets pledged as collateral for our derivatives. The cash and cash equivalents and agency securities pledged as collateral for our derivative instruments is included in restricted cash and agency securities, respectively, on our consolidated

balance sheets.

Each of our ISDA Master Agreements contains provisions under which we are required to fully collateralize our obligations under the swap instrument if at any point the fair value of the swap represents a liability greater than the minimum transfer amount contained within our agreements. We were also required to post initial collateral upon execution of certain of our swap transactions. If we breach any of these provisions, we will be required to settle our obligations under the agreements at their termination values.

Further, each of our ISDA Master Agreements also contains a cross default provision under which a default under certain of our other indebtedness in excess of a certain threshold causes an event of default under the agreement. Threshold amounts vary by lender. Following an event of default, we could be required to settle our obligations under the agreements at their termination values. Additionally, under certain of our ISDA Master Agreements, we could be required to settle our obligations under the agreements at their termination values if we fail to maintain certain minimum shareholders' equity thresholds or our REIT status or comply with limits on our leverage above certain specified levels.

As of September 30, 2011, the fair value of our interest rate swaps in a liability position related to these agreements was \$754.8 million. We had agency securities with fair values of \$633.7 million, and restricted cash of \$317.0 million, or \$950.7 million in total agency securities and restricted cash, pledged as collateral against our interest rate swaps, including initial collateral posted upon execution of interest rate swap and total return swap transactions, as of September 30, 2011. Termination values of interest rate swaps in a liability position totaled \$765.7 million as of September 30, 2011. The difference between the fair value liability and the termination liability represents accrued interest and an adjustment for nonperformance risk of our counterparties.

#### Note 7. Fair Value Measurements

ASC 820 provides for a three-level valuation hierarchy for disclosure of fair value measurement. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. There were no transfers between hierarchy levels during the nine months ended September 30, 2011 and 2010. The three levels of hierarchy are defined as follows:

• **Level 1 Inputs** —Quoted prices (unadjusted) for identical unrestricted assets and liabilities in active markets that are accessible at the measurement date.

**Level 2 Inputs** —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 3 Inputs** —Instruments with primarily unobservable market data that cannot be corroborated.

All of our agency securities and derivative and hedging assets and liabilities were valued based on the income or market approach using Level 2 inputs as of September 30, 2011 and December 31, 2010.

#### Note 8. Stockholders' Equity

##### Equity Offerings

During the nine months ended September 30, 2011, we completed three follow-on public offerings of shares of our common stock summarized in the table below (in thousands, except per share amounts):

| Public Offering           | Price Received<br>Per Share <sup>(1)</sup> | Shares  | Net Proceeds <sup>(2)</sup> |
|---------------------------|--------------------------------------------|---------|-----------------------------|
| January 2011              | \$28.00                                    | 26,910  | \$719,250                   |
| March 2011 <sup>(3)</sup> | \$27.72                                    | 32,200  | 892,233                     |
| June 2011 <sup>(3)</sup>  | \$27.56                                    | 49,680  | 1,368,848                   |
| Total                     |                                            | 108,790 | \$2,980,331                 |

(1) Price received per share is gross of underwriters' discount, if applicable.

(2) Net proceeds are net of the underwriters' discount, if applicable, and other offering costs.

Shares of our common stock were sold to underwriters, who sold the shares in one or more transactions on the

(3) Nasdaq Global Select Market, in the over-the-counter market, through negotiated transactions or otherwise at market prices prevailing at the time of sale.

In November 2011, we completed a public offering in which 40.5 million shares of our common stock were sold to the

underwriters at a price of \$27.36 per share. The underwriters in the offering sold the shares of our common stock in one or more transactions on the Nasdaq Global Select Market, in the over-the-counter market, through negotiated transactions or otherwise at market prices prevailing at the time of sale. Upon completion of the offering we received proceeds, net of offering expenses, of approximately \$1.1 billion.

#### Controlled Equity Offering<sup>SM</sup> Program

We have a sales agreement with an underwriter to, from time-to-time, publicly offer and sell up to 15 million shares of our common stock in privately negotiated and/or at-the-market transactions. During the three month period ended September 30, 2011, we sold 5.1 million shares of our common stock under the sales agreement at an average offering price of \$29.07 per share for proceeds, net of the underwriter's discount and other program costs, of \$146.9 million. During the nine month period ended September 30, 2011, we sold 9.4 million shares of our common stock under the sales agreement at an average offering price of \$29.23 per share for proceeds, net of the underwriter's discount and other program costs, of \$273.0 million. As of September 30, 2011, 1.2 million shares of our common stock remain available for issuance under the sales agreement.

#### Dividend Reinvestment and Direct Stock Purchase Plan

We sponsor a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of our common stock by reinvesting some or all of the cash dividends received on shares of our common stock. Stockholders may also make optional cash purchases of shares of our common stock subject to certain limitations detailed in the plan prospectus. During the three month period ended September 30, 2011, there were no shares issued under the plan. During the nine month period ended September 30, 2011, we issued 0.5 million shares under the plan for net cash proceeds of \$14.9 million. As of September 30, 2011, there were 4.7 million shares available for issuance under the plan.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is designed to provide a reader of American Capital Agency Corp.'s consolidated financial statements with a narrative from the perspective of management. Our MD&A is presented in five sections:

Executive Overview

Financial Condition

Results of Operations

Liquidity and Capital Resources

Forward-Looking Statements

### EXECUTIVE OVERVIEW

American Capital Agency Corp. ("AGNC", the "Company", "we", "us" and "our") was organized on January 7, 2008 and commenced operations on May 20, 2008 following the completion of our initial public offering ("IPO"). Our common stock is traded on The NASDAQ Global Select Market under the symbol "AGNC".

We earn income primarily from investing in residential mortgage pass-through securities and collateralized mortgage obligations ("CMOs") on a leveraged basis. These investments consist of securities for which the principal and interest payments are guaranteed by U.S. Government-sponsored entities ("GSEs"), such as the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or by a U.S. Government agency, such as the Government National Mortgage Association, ("Ginnie Mae"). We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio. Our principal objective is to preserve our net asset value (also referred to as "stockholders' equity") within reasonable bands while generating attractive risk-adjusted returns for distribution to our stockholders through regular quarterly dividends from the combination of our net interest income and net realized gains and losses on our investments and other hedging activities. Our net interest income consists of the spread between the interest income earned on our agency securities and the interest costs of our borrowings and derivatives accounted for as hedges for accounting purposes (please refer to Notes 3 and 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q

regarding discontinuation of hedge accounting as of September 30, 2011). We fund our investments primarily through short-term borrowings structured as repurchase agreements.

We have elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as

amended (the "Code"). As such, we are required to distribute annually 90% of our taxable net income. As long as we qualify as a REIT, we will generally not be subject to U.S. federal or state corporate taxes on our taxable net income to the extent that we distribute all of our annual taxable net income to our stockholders. We are externally managed by American Capital AGNC Management, LLC ("our Manager"), an affiliate of American Capital, Ltd. ("American Capital").

#### Our Investment Strategy

Our investment strategy is to manage an investment portfolio consisting exclusively of agency securities (other than for hedging purposes) that seeks to generate attractive, risk-adjusted returns. Specifically, our investment strategy is designed to:

- manage an investment portfolio consisting of agency securities that seeks to generate attractive risk-adjusted returns;
- capitalize on discrepancies in the relative valuations in the agency securities market;
- manage financing, interest and prepayment rate risks;
- preserve our net asset value within reasonable bands;
- provide regular quarterly distributions to our stockholders;
- qualify as a REIT; and
- remain exempt from the requirements of the Investment Company Act of 1940, as amended (the "Investment Company Act").

#### Trends and Recent Market Impacts

Thus far, the year 2011 has been marked by extreme volatility in the U.S. markets fueled by an array of significant global economic and political events, including slow U.S. economic growth, the worsening European debt crisis, the congressional debt ceiling debate and S&P's downgrade of its U.S. sovereign debt ratings. In addition, following the conclusion of "QE2" in June 2011, the Federal Reserve continued their efforts to try to help stimulate the U.S. economy with their September 2011 announcement of "Operation Twist" and their plan to reinvest principal and interest received from their holdings of agency securities into new purchases of agency securities, each designed to reduce mortgage and interest rates. These events led to a decline in the 10 year U.S. Treasury rate from 3.30% at the beginning of 2011 to as low as 1.72% during September 2011, ending the month of September at 1.92%. Fixed-rate mortgage rates also experienced significant declines, reaching their historical lowest levels during the third quarter. Low mortgage rates, coupled with changes to the GSE's underwriting practices and the anticipated announcement by the Federal Housing Finance Authority ("FHFA") regarding changes to the government sponsored Home Affordable Refinance Program ("HARP") intended to extend HARP's reach to a larger number of underwater borrowers, drove escalating prepayment fears during the third quarter.

Despite the extreme volatility, we declared a cash dividend of \$1.40 per share for each of the three quarters ended September 30, 2011, while increasing our net book value per share and undistributed taxable income per share sequentially over the past three quarters, from \$24.24 net book value per share as of December 31, 2010 to \$26.90 per share as of September 30, 2011 and from \$0.60 undistributed taxable income per share as of December 31, 2010 to \$0.85 per share as of September 30, 2011.

In addition, during the third quarter, we executed a number of significant actions intended to reduce risk and increase the durability of our returns. These actions included increasing our use of longer term repurchase agreements, proactively managing our counterparty exposure, significantly increasing our ratio of interest rate swaps to our repurchase agreement financings and continuing to enhance our portfolio to our highest percentage of assets backed by loans that our Manager views as having favorable prepayment characteristics, with 93% of our 15-year securities and 86% of our 30-year securities backed by either lower loan balance loans or higher loan-to-value loans refinanced through HARP. We believe that less than 5% of our holdings are likely to be affected by the changes to the HARP program announced on October 24, 2011 as a result of our Manager's active portfolio management.

#### FINANCIAL CONDITION

As of September 30, 2011 and December 31, 2010, our investment portfolio consisted of \$42.0 billion and \$13.5 billion, respectively, of agency securities. The following tables summarize certain characteristics of our investment portfolio as of September 30, 2011 (dollars in thousands):



|                                                                                      | As of September 30, 2011 |                |                      |              | Weighted Average |                      |       | CPR <sup>(2)</sup> |   |
|--------------------------------------------------------------------------------------|--------------------------|----------------|----------------------|--------------|------------------|----------------------|-------|--------------------|---|
|                                                                                      | Par Value                | Amortized Cost | Amortized Cost Basis | Fair Value   | Coupon           | Yield <sup>(1)</sup> |       |                    |   |
| Agency Securities Classified as Available-For-Sale:                                  |                          |                |                      |              |                  |                      |       |                    |   |
| Fannie Mae                                                                           | \$22,477,679             | \$23,465,391   | 104.4 %              | \$23,920,324 | 4.18             | 3.15                 |       | 13.11              | % |
| Freddie Mac                                                                          | 16,695,524               | 17,403,540     | 104.2 %              | 17,733,081   | 4.14             | 3.17                 |       | 12.28              | % |
| Ginnie Mae                                                                           | 102,938                  | 106,681        | 103.6 %              | 108,788      | 4.15             | 2.17                 |       | 32.04              | % |
| Total / Weighted Average Available-For-Sale Agency Securities                        | \$39,276,141             | \$40,975,612   | 104.3 %              | \$41,762,193 | 4.16             | 3.15                 |       | 12.80              | % |
| Fixed-Rate                                                                           |                          |                |                      |              |                  |                      |       |                    |   |
| ≤ 15 Year                                                                            |                          |                |                      |              |                  |                      |       |                    |   |
| Lower Loan Balance <sup>(3)</sup>                                                    | \$18,242,870             | \$18,916,760   | 103.7 %              | \$19,320,604 | 3.83             | 2.94                 |       | 10.39              | % |
| HARP <sup>(4)</sup>                                                                  | 998,692                  | 1,039,375      | 104.1 %              | 1,056,742    | 3.96             | 2.91                 |       | 12.84              | % |
| Other <sup>(5)</sup>                                                                 | 1,553,673                | 1,597,119      | 102.8 %              | 1,629,567    | 3.67             | 2.84                 |       | 13.43              | % |
| Total ≤ 15 Year                                                                      | 20,795,235               | 21,553,254     | 103.6 %              | 22,006,913   | 3.82             | 2.93                 |       | 10.73              | % |
| 30 Year: <sup>(6)</sup>                                                              |                          |                |                      |              |                  |                      |       |                    |   |
| Lower Loan Balance <sup>(3)</sup>                                                    | 4,725,992                | 5,011,051      | 106.0 %              | 5,065,501    | 4.52             | 3.49                 |       | 9.86               | % |
| HARP <sup>(4)</sup>                                                                  | 8,304,864                | 8,749,268      | 105.4 %              | 8,906,753    | 4.60             | 3.57                 |       | 11.78              | % |
| Other (2009-2011 Vintage)                                                            | 1,456,452                | 1,505,812      | 103.4 %              | 1,546,335    | 4.41             | 3.64                 |       | 15.06              | % |
| Other (Pre 2009 Vintage)                                                             | 691,229                  | 735,426        | 106.4 %              | 752,755      | 5.62             | 3.50                 |       | 22.99              | % |
| Total 30 Year                                                                        | 15,178,537               | 16,001,557     | 105.4 %              | 16,271,344   | 4.61             | 3.55                 |       | 12.00              | % |
| Total Fixed-Rate                                                                     | 35,973,772               | 37,554,811     | 104.4 %              | 38,278,257   | 4.15             | 3.20                 |       | 11.27              | % |
| Adjustable-Rate                                                                      |                          |                |                      |              |                  |                      |       |                    |   |
| CMO                                                                                  | 3,067,123                | 3,179,456      | 103.7 %              | 3,237,779    | 4.28             | 2.76                 |       | 29.47              | % |
|                                                                                      | 235,246                  | 241,345        | 102.6 %              | 246,157      | 3.75             | 1.67                 |       | 29.92              | % |
| Total / Weighted Average Available- For-Sale Securities                              | \$39,276,141             | \$40,975,612   | 104.3 %              | \$41,762,193 | 4.16             | 3.15                 |       | 12.80              | % |
| Agency Securities Remeasured at Fair Value Through Earnings:                         |                          |                |                      |              |                  |                      |       |                    |   |
| Interest-Only Strips                                                                 |                          |                |                      |              |                  |                      |       |                    |   |
| Fannie Mae                                                                           | \$833,893                | \$119,049      | \$107,454            | 5.54         | 6.57             |                      | 25.71 | %                  |   |
| Freddie Mac                                                                          | 488,884                  | 71,286         | 60,759               | 5.62         | 10.87            |                      | 22.46 | %                  |   |
| Principal-Only Strips                                                                |                          |                |                      |              |                  |                      |       |                    |   |
| Fannie Mae                                                                           | 43,273                   | 37,961         | 40,013               | —            | 5.13             |                      | 29.00 | %                  |   |
| Total / Weighted Average Agency Securities Remeasured at Fair Value Through Earnings | \$1,366,050              | \$228,296      | \$208,226            | 5.39         | 7.67             |                      | 22.46 | %                  |   |

(1)

Incorporates an average future constant prepayment rate assumption of 13% based on forward rates as of September 30, 2011 and an average reset rate for adjustable rate securities of 2.76%, which is equal to the average underlying index rate of 0.96% based on the current spot rate in effect as of the date we acquired the securities and an average margin of 1.80%.

(2) Average projected life CPR as of September 30, 2011.

Lower loan balance securities represent pools backed by a maximum original loan balance of up to \$150 thousand.

(3) Our lower loan balance securities had a weighted average original loan balance of \$104 thousand and \$100 thousand for 15 year and 30 year securities, respectively, as of September 30, 2011.

HARP securities are defined as pools backed by 100% refinance loans with loan-to-values (LTV) between 80% and

(4) 125%. Our HARP securities had a weighted average LTV of 95% and 100% for 15 year and 30 year securities, respectively, as of September 30, 2011.

(5) 15 year securities include \$643 million of securities backed by loans with original loan balances  $\leq$  \$175 thousand.

(6) 30 year securities include \$841 million and \$87 million of 20 and 40 year securities, respectively.

Interest-only securities represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance ("UPB" or "par value") of specific CMO securities. Principal-only securities represent the right to receive contractual principal flows of the UPB of specific CMO securities. The interest cash flows

from our interest-only securities taken together with interest cash flows from our fixed-rate, adjustable-rate and CMO securities, total 4.35% of the combined par value our agency securities (excluding the UPB of our interest-only securities) as of September 30, 2011. The combined weighted average yield of our agency portfolio was 3.18% as of September 30, 2011.

The following table summarizes certain characteristics of our investment portfolio as of December 31, 2010 (dollars in thousands):

|                                                                | As of December 31, 2010 |                |                      |                |                         |                      |                    |   |  |  |
|----------------------------------------------------------------|-------------------------|----------------|----------------------|----------------|-------------------------|----------------------|--------------------|---|--|--|
|                                                                | Par Value               | Amortized Cost | Amortized Cost Basis | Fair Value     | Weighted Average Coupon | Yield <sup>(1)</sup> | CPR <sup>(2)</sup> |   |  |  |
| Agency Securities Classified as Available-For-Sale:            |                         |                |                      |                |                         |                      |                    |   |  |  |
| Fannie Mae                                                     | \$8,207,464             | \$8,557,281    | 104.3                | % \$8,559,569  | 4.51                    | % 3.31               | % 11.32            | % |  |  |
| Freddie Mac                                                    | 4,599,712               | 4,819,133      | 104.8                | % 4,788,706    | 4.45                    | % 3.11               | % 11.72            | % |  |  |
| Ginnie Mae                                                     | 100,408                 | 105,078        | 104.7                | % 105,266      | 4.37                    | % 2.14               | % 23.61            | % |  |  |
| Total / Weighted Average Available-For-Sale Agency Securities  | \$12,907,584            | \$13,481,492   | 104.4                | % \$13,453,541 | 4.49                    | % 3.23               | % 11.56            | % |  |  |
| Fixed-Rate                                                     |                         |                |                      |                |                         |                      |                    |   |  |  |
| ≤ 15 Year                                                      | \$5,226,452             | \$5,412,261    | 103.6                | % \$5,373,165  | 4.28                    | % 3.09               | % 7.07             | % |  |  |
| 30 Year <sup>(3)</sup>                                         | 3,553,239               | 3,732,091      | 105.0                | % 3,728,314    | 4.97                    | % 3.99               | % 10.04            | % |  |  |
| Total Fixed-Rate                                               | 8,779,691               | 9,144,352      | 104.2                | % 9,101,479    | 4.29                    | % 3.45               | % 8.28             | % |  |  |
| Adjustable-Rate                                                |                         |                |                      |                |                         |                      |                    |   |  |  |
| CMO                                                            | 3,745,363               | 3,942,937      | 105.3                | % 3,950,164    | 4.96                    | % 2.69               | % 18.34            | % |  |  |
|                                                                | 382,530                 | 394,203        | 103.1                | % 401,898      | 4.27                    | % 3.52               | % 19.71            | % |  |  |
| Total / Weighted Average Available- For-Sale Agency Securities | \$12,907,584            | \$13,481,492   | 104.4                | % \$13,453,541 | 4.49                    | % 3.23               | % 11.56            | % |  |  |

|                                                                                            | As of December 31, 2010                           |                   |            |                  |                      |   |                    |   |
|--------------------------------------------------------------------------------------------|---------------------------------------------------|-------------------|------------|------------------|----------------------|---|--------------------|---|
|                                                                                            | Underlying<br>Unamortized<br>Principal<br>Balance | Amortized<br>Cost | Fair Value | Weighted Average |                      |   |                    |   |
|                                                                                            |                                                   |                   |            | Coupon           | Yield <sup>(1)</sup> |   | CPR <sup>(2)</sup> |   |
| Agency Securities Remeasured at<br>Fair Value Through Earnings:                            |                                                   |                   |            |                  |                      |   |                    |   |
| Interest-Only Securities                                                                   |                                                   |                   |            |                  |                      |   |                    |   |
| Fannie Mae                                                                                 | \$229,980                                         | \$18,957          | \$20,425   | 4.18             | % 15.48              | % | 13.49              | % |
| Freddie Mac                                                                                | 314,705                                           | 33,447            | 36,314     | 5.52             | % 27.23              | % | 11.75              | % |
| Total / Weighted Average Agency<br>Securities Remeasured at Fair<br>Value Through Earnings | \$544,685                                         | \$52,404          | \$56,739   | 4.95             | % 22.98              | % | 12.38              | % |

Incorporates an average future constant prepayment rate assumption of 12% based on forward rates as of December 31, 2010 and an average reset rate for adjustable rate securities of 2.76%, which is equal to the average underlying index rate of 0.94% based on the current spot rate in effect as of the date we acquired the securities and an average margin of 1.82%

(2)Average projected life CPR as of December 31, 2010.

(3)30 year securities include \$802 million and \$81 million of 20 and 40 year securities, respectively.

As of December 31, 2010, the interest cash flows from our interest-only securities taken together with interest cash flows from our fixed-rate, adjustable-rate and CMO securities, total 4.70% of the combined par value our agency securities (excluding the UPB of our interest-only securities). The combined weighted average yield of our agency portfolio was 3.31% as of December 31, 2010.

As of September 30, 2011 and December 31, 2010, we held fixed-rate pass-through agency securities, pass-through agency securities collateralized by ARMs and hybrid ARMs, with coupons linked to various indices. The following tables detail the characteristics of our ARM and hybrid ARM portfolio by index as of September 30, 2011 and December 31, 2010 (dollars in thousands):

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|                                                             | As of September 30, 2011 |                   |                      |                                     | As of December 31, 2010 |                   |                      |                                     |   |
|-------------------------------------------------------------|--------------------------|-------------------|----------------------|-------------------------------------|-------------------------|-------------------|----------------------|-------------------------------------|---|
|                                                             | Six-Month<br>Libor       | One-Year<br>Libor | One-Year<br>Treasury | Twelve-Month<br>Treasury<br>Average | Six-Month<br>Libor      | One-Year<br>Libor | One-Year<br>Treasury | Twelve-Month<br>Treasury<br>Average |   |
| Weighted<br>average<br>term to next<br>reset<br>(months)    | 37                       | 81                | 42                   | 29                                  | 39                      | 75                | 48                   | 35                                  |   |
| Weighted<br>average<br>margin                               | 1.59                     | % 1.79            | % 1.91               | % 1.84                              | % 1.53                  | % 1.75            | % 2.14               | % 1.83                              | % |
| Weighted<br>average<br>annual<br>period cap                 | 1.09                     | % 2.00            | % 1.57               | % 1.00                              | % 1.23                  | % 2.00            | % 1.86               | % 1.00                              | % |
| Weighted<br>average<br>lifetime cap                         | 10.59                    | % 9.17            | % 9.90               | % 10.08                             | % 10.86                 | % 9.88            | % 10.28              | % 10.13                             | % |
| Principal<br>amount                                         | \$99,470                 | \$2,520,583       | \$227,669            | \$219,401                           | \$141,318               | \$2,683,203       | \$659,825            | \$261,017                           |   |
| Percentage<br>of<br>investment<br>portfolio at<br>par value | 0.25                     | % 6.33            | % 0.58               | % 0.56                              | % 1.00                  | % 21.00           | % 5.00               | % 2.00                              | % |

The following table details the number of months to the next reset for our pass-through securities collateralized by ARMs and hybrid ARMs as of September 30, 2011 and December 31, 2010 (dollars in thousands):

|                                                               | As of September 30, 2011 |         |                  | As of December 31, 2010 |         |                  |
|---------------------------------------------------------------|--------------------------|---------|------------------|-------------------------|---------|------------------|
|                                                               | Fair Value               | % Total | Average<br>Reset | Fair Value              | % Total | Average<br>Reset |
| Less than one year                                            | \$24,679                 | 1       | % 6              | \$25,803                | 1       | % 7              |
| Greater than or equal to one year and less than two years     | 137,090                  | 4       | % 19             | 218,928                 | 5       | % 18             |
| Greater than or equal to two years and less than three years  | 387,362                  | 12      | % 29             | 737,130                 | 19      | % 33             |
| Greater than or equal to three years and less than five years | 385,898                  | 12      | % 44             | 1,010,349               | 26      | % 47             |
| Greater than or equal to five years                           | 2,302,750                | 71      | % 89             | 1,957,954               | 49      | % 94             |
| Total / Weighted Average                                      | \$3,237,779              | 100     | % 73             | \$3,950,164             | 100     | % 66             |

Actual maturities of agency securities are generally shorter than stated contractual maturities primarily as a result of prepayments of principal of the underlying mortgages. The stated contractual final maturity of the mortgage loans underlying our portfolio of agency securities ranges up to 40 years, but the expected maturity is subject to change based on the actual and expected future prepayments of the underlying loans. As of September 30, 2011 and December 31, 2010, the average final contractual maturity of the agency securities in our investment portfolio was 21 and 22 years, respectively. The estimated weighted average months to maturity of the agency securities in the table below are based upon our prepayment expectations, which are estimated based on assumptions for different securities using a combination of third-party services, market data and internal models. The third-party services estimate

prepayment speeds using models that incorporate the forward yield curve, mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors. As market conditions are changing rapidly, we use judgment in making adjustments to our models for some products. Various market participants could use materially different assumptions.

The following table summarizes our agency securities classified as available-for-sale, at fair value, according to their estimated weighted average life classifications as of September 30, 2011 and December 31, 2010 (in thousands):

| Estimated Weighted Average Life of Agency Securities Classified as Available-for-Sale | As of September 30, 2011 |                |                         | As of December 31, 2010 |                |                         |   |
|---------------------------------------------------------------------------------------|--------------------------|----------------|-------------------------|-------------------------|----------------|-------------------------|---|
|                                                                                       | Fair Value               | Amortized Cost | Weighted Average Coupon | Fair Value              | Amortized Cost | Weighted Average Coupon |   |
| Less than or equal to one year                                                        | \$3,097                  | \$3,112        | 5.50 %                  | \$—                     | \$—            | —                       | % |
| Greater than one year and less than or equal to three years                           | 7,769,007                | 7,613,464      | 4.32 %                  | 133,123                 | 132,520        | 5.05                    | % |
| Greater than three years and less than or equal to five years                         | 30,555,145               | 29,971,368     | 4.09 %                  | 3,841,282               | 3,821,992      | 4.92                    | % |
| Greater than five years                                                               | 3,434,944                | 3,387,668      | 4.43 %                  | 9,479,136               | 9,526,980      | 4.31                    | % |
| Total                                                                                 | \$41,762,193             | \$40,975,612   | 4.16 %                  | \$13,453,541            | \$13,481,492   | 4.49                    | % |

The weighted average life of our interest-only and principal-only securities was 2.7 and 6.2 years as of September 30, 2011 and December 31, 2010, respectively.

The constant prepayment rate (“CPR”) reflects the percentage of principal that is prepaid over a period of time on

an annualized basis. In general, while there are various factors that impact the rate of prepayments, as interest rates rise, the rate of refinancings typically declines, which may result in lower rates of prepayment and, as a result, a lower portfolio CPR. Conversely, as interest rates fall, the rate of refinancings typically increases, which may result in higher rates of prepayment and, as a result, a higher portfolio CPR. As of September 30, 2011, our portfolio was purchased at a net premium.

In determining the estimated weighted average months to maturity of our agency securities and the yield on our agency securities, we have assumed that the CPR over the remaining projected life of our aggregate investment portfolio is 13% as of September 30, 2011. We make different prepayment assumptions for the individual securities that comprise the investment portfolio and these individual assumptions can differ materially from the average. There is also considerable uncertainty around prepayment speeds in this environment and actual speeds could differ materially from our estimates. Changes to the GSE's underwriting standards, further modifications to existing U.S. government sponsored programs such as HARP or the implementation of new programs could materially impact prepayment speeds. Furthermore, GSE buyouts of loans in imminent risk of default, loans that have been modified, or loans that have defaulted will generally be reflected as prepayments on agency securities and also increase the uncertainty around these estimates. In addition, securities were purchased with different amounts of premiums and therefore the yield on some securities is more sensitive to changes in prepayment speeds.

## RESULTS OF OPERATIONS

The following analysis of our financial condition and results of operations should be read in conjunction with our interim consolidated financial statements and the notes thereto. The tables below present our condensed consolidated balance sheets as of September 30, 2011 and December 31, 2010 and our consolidated statements of operations and key statistics for the three and nine months ended September 30, 2011 and 2010 (in thousands, except per share amounts):

| Balance Sheet Data:                                              | As of<br>September 30,<br>2011 | December 31, 2010 |
|------------------------------------------------------------------|--------------------------------|-------------------|
| Investment portfolio, at fair value                              | \$41,970,419                   | \$ 13,510,280     |
| Total assets                                                     | \$47,039,429                   | \$ 14,475,829     |
| Repurchase agreements and other debt                             | \$38,898,483                   | \$ 11,753,019     |
| Total liabilities                                                | \$42,099,173                   | \$ 12,903,765     |
| Total stockholders' equity                                       | \$4,940,256                    | \$ 1,572,064      |
| Net asset value per common share as of period end <sup>(1)</sup> | \$26.90                        | \$ 24.24          |

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| Consolidated Statement of Operations Data:                                 | For the three months ended September 30, |           | For the nine months ended September 30, |            |
|----------------------------------------------------------------------------|------------------------------------------|-----------|-----------------------------------------|------------|
|                                                                            | 2011                                     | 2010      | 2011                                    | 2010       |
| Interest income                                                            | \$326,754                                | \$62,600  | \$755,975                               | \$151,986  |
| Interest expense                                                           | 95,036                                   | 18,531    | 194,500                                 | 51,389     |
| Net interest income                                                        | 231,718                                  | 44,069    | 561,475                                 | 100,597    |
| Gain on sale of agency securities, net                                     | 262,768                                  | 24,565    | 360,880                                 | 81,558     |
| Realized loss on periodic interest settlements of interest rate swaps, net | (1,773)                                  | ) —       | (1,773)                                 | ) —        |
| Other realized loss on derivative instruments and other securities, net    | (173,190)                                | ) (736)   | ) (222,594)                             | ) (4,214)  |
| Unrealized loss on derivative instruments and other securities, net        | (46,543)                                 | ) (2,997) | ) (85,623)                              | ) (15,466) |
| Total other income, net                                                    | 41,262                                   | 20,832    | 50,890                                  | 61,878     |
| Management fees                                                            | 15,634                                   | 2,697     | 36,511                                  | 6,795      |
| General and administrative expenses                                        | 5,845                                    | 1,926     | 12,988                                  | 5,394      |
| Total expenses                                                             | 21,479                                   | 4,623     | 49,499                                  | 12,189     |
| Income before tax                                                          | 251,501                                  | 60,278    | 562,866                                 | 150,286    |
| Excise tax                                                                 | 1,100                                    | 250       | 1,100                                   | 250        |
| Net income                                                                 | \$250,401                                | \$60,028  | \$561,766                               | \$150,036  |
| Net income per common share—basic and diluted                              | \$1.39                                   | \$1.69    | \$4.19                                  | \$4.97     |
| Weighted average number of common shares outstanding—basic and diluted     | 180,725                                  | 35,495    | 134,163                                 | 30,161     |
| Dividends declared                                                         | \$1.40                                   | \$1.40    | \$4.20                                  | \$4.20     |

| Other Data:                                                               | For the three months ended September 30, |             | For the nine months ended September 30, |             |
|---------------------------------------------------------------------------|------------------------------------------|-------------|-----------------------------------------|-------------|
|                                                                           | 2011                                     | 2010        | 2011                                    | 2010        |
| Average agency securities, at cost                                        | \$41,667,838                             | \$7,751,068 | \$30,923,323                            | \$5,912,577 |
| Average agency securities, at cost—percent of par value                   | 104.5                                    | % 104.6     | % 104.4                                 | % 104.2     |
| Average total assets, at fair value                                       | \$47,077,307                             | \$8,454,760 | \$34,095,124                            | \$6,515,662 |
| Average repurchase agreements and other debt <sup>(2)</sup>               | \$38,484,147                             | \$7,241,783 | \$28,354,578                            | \$5,536,394 |
| Average stockholders' equity <sup>(3)</sup>                               | \$4,871,687                              | \$853,250   | \$3,698,516                             | \$713,925   |
| Average coupon <sup>(4)</sup>                                             | 4.40                                     | % 5.03      | % 4.47                                  | % 5.12      |
| Average asset yield <sup>(5)</sup>                                        | 3.14                                     | % 3.23      | % 3.25                                  | % 3.42      |
| Average cost of funds <sup>(6)</sup>                                      | 1.00                                     | % 1.02      | % 0.93                                  | % 1.09      |
| Average cost of funds—terminated swap amortization expense <sup>(7)</sup> | —                                        | —           | —                                       | 0.15        |
| Average net interest rate spread <sup>(8)</sup>                           | 2.14                                     | % 2.21      | % 2.33                                  | % 2.18      |
| Average actual CPR for securities held during the period                  | 8                                        | % 15        | % 9                                     | % 20        |
| Average forecasted CPR as of period end                                   | 13                                       | % 18        | % 13                                    | % 18        |
| Leverage (average during the period) <sup>(9)</sup>                       | 7.9:1                                    | 8.5:1       | 7.7:1                                   | 7.8:1       |
| Leverage (as of period end) <sup>(10)</sup>                               | 7.7:1                                    | 9.8:1       | 7.7:1                                   | 9.8:1       |
| Annualized expenses % of average assets <sup>(11)</sup>                   | 0.18                                     | % 0.22      | % 0.19                                  | % 0.25      |
| Annualized expenses % of average equity <sup>(12)</sup>                   | 1.75                                     | % 2.15      | % 1.79                                  | % 2.28      |

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|                                                            |      |        |        |        |   |
|------------------------------------------------------------|------|--------|--------|--------|---|
| Net return on average stockholders' equity <sup>(13)</sup> | 20.4 | % 27.9 | % 20.3 | % 28.1 | % |
| Annualized economic return <sup>(14)</sup>                 | 22.9 | % 21.7 | % 37.8 | % 30.6 | % |

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- \* Average numbers for each period are weighted based on days on our books and records, all percentages are annualized.
- (1) Net asset value per common share was calculated by dividing our total stockholders' equity by our number of shares outstanding.
  - (2) Average repurchase agreement and other debt represents their daily weighted average balances, less amounts used to fund short-term investments in U.S. treasury securities.
  - (3) Average stockholders' equity calculated as the average month-end stockholders' equity balance outstanding during the period.
  - (4) Weighted average coupon for the period was calculated by dividing our total coupon (or cash) interest income on our agency securities by our daily weighted average agency securities.
  - (5) Weighted average asset yield for the period was calculated by dividing our total interest income on our agency securities, including amortization of premiums and discounts, by our daily weighted average agency securities. Weighted average cost of funds for the period was calculated by dividing our total interest expense by our daily weighted average repurchase agreements and other debt. Total interest expense excludes amortization expense related to the costs of the previously terminated interest rate swaps during the periods presented. Cost of funds includes both interest rate swaps that have been designated and not designated as hedges under GAAP.
  - (6) Represents amortization expense associated with interest rate swaps terminated in a prior period of \$6.3 million for the nine months ended September 30, 2010.
  - (8) Average net interest rate spread for the period was calculated by subtracting our weighted average cost of funds, net of interest rate swaps and terminated swap amortization expense, from our weighted average asset yield. Leverage during the period was calculated by dividing the our daily weighted average repurchase agreements and other debt outstanding, less amounts used to fund short-term investments in U.S. treasury securities, for the period by our average month-ended stockholders' equity for the period.
  - (9) Leverage at period end was calculated by dividing the sum of the amount outstanding under our repurchase agreements, net receivable/payable for unsettled agency securities and other debt by our total stockholders' equity at period end.
  - (10) Annualized expenses as a percentage of average total assets was calculated by dividing our total expenses by our average total assets on an annualized basis.
  - (11) Annualized expenses as a percentage of average stockholders' equity was calculated by dividing our total expenses by our average stockholders' equity on an annualized basis.
  - (12) Annualized net return on average stockholders' equity for the period was calculated by dividing our net income by our average stockholders' equity on an annualized basis.
  - (13) Annualized economic return represents the sum of the change in net asset value over the period and dividends declared during the period over the beginning net asset value on an annualized basis.
  - (14)

#### Interest Income and Asset Yield

Interest income was \$326.8 million and \$62.6 million for the current and prior three month periods ended September 30, 2011 and 2010, respectively, and \$756.0 million and \$152.0 million for the current and prior nine month periods ended September 30, 2011 and 2010, respectively. The year-over-year increases in interest income were due to an increase in our average investment portfolio, partially offset by a decline in our average asset yield. Our average asset yield declined year-over-year to 3.14% from 3.23% for the current and prior year three month periods, respectively, and declined to 3.25% from 3.42% for the current and prior year nine month periods, respectively. The decline in our average asset yield is primarily the result of acquiring lower yielding securities due to changes in portfolio composition discussed in "Trends and Market Impacts" in the Executive Overview. Specifically, changes in our portfolio composition had the effect of lowering the average coupon of our investment portfolio, while the average amortized cost basis of our investment portfolio remained relatively unchanged. The average coupon of our investment portfolio declined year-over-year to 4.40% from 5.03% for the current and prior year three month period, respectively, and to 4.47% from 5.12% for the current and prior year nine month periods, respectively. The amortized cost basis of our investment portfolio was 104.50%, 104.60%, 104.40% and 104.20% for the current and

prior year three and nine month periods, respectively. The year-over-year declines in the average coupon of our investment portfolio was partially offset by year-over-year declines in actual and projected CPRs on our investment portfolio.

We amortize premiums and discounts associated with agency securities into interest income over the life of such securities using the effective yield method. The effective yield (or asset yield) on our agency securities is based on actual CPRs realized for individual securities in our investment portfolio through the reporting date and assumes a CPR over the remaining projected life of our aggregate investment portfolio of 13% and 18% as of September 30, 2011 and 2010, respectively. The actual CPR realized for individual securities in our investment portfolio was approximately 8% and 15% for the current and prior year three month periods, respectively, and 9% and 20% for the current and prior year nine month periods, respectively. The three month period year-over-year decrease in the actual and forecasted CPRs was due to changes in our portfolio composition to our highest percentage of assets backed by loans with favorable prepayment characteristics, lower coupons and newer mortgages, despite a decline in long-term interest rates to historically low levels during the current three month period. The nine month period year-over-year decrease in actual and forecasted CPRs further benefited from a decline in GSE buyouts of delinquent loans from mortgage pools collateralizing agency securities, which had the impact of increasing the average prepayment speed of our portfolio during the prior year period.

Additionally, pursuant to ASC 310-20, the yield on our adjustable rate securities assumes that the securities reset at a rate

equal to the underlying index rate in effect as of the date we acquired the security plus the stated margin. Consequently, future reset rate assumptions incorporated in our asset yields may differ materially from future reset rates implied by the forward yield curve and the actual reset rates ultimately achieved. Further, notwithstanding changes to our actual and projected CPR assumptions, the lower our reset rate assumption is pursuant to ASC 310-20 than the current fixed rate in effect, the greater the rate of premium amortization we will recognize over the initial fixed rate period. Our adjustable rate portfolio was acquired for a premium above par value and most securities were acquired during a period of historically low index rates. Accordingly, the the premium balance on our adjustable rate securities will generally be fully amortized prior to their first reset date, regardless of actual or forecasted prepayment speeds and changes in the underlying index rates prior to actual reset. Adjustable rate securities acquired during a different interest rate environment may experience a different premium amortization pattern even as current index rates remain near their historical lows. For adjustable rate securities held as of September 30, 2011, the weighted average coupon rate was 4.28% weighted average months to reset was 73 months and the weighted average reset rate assumption was 2.76%, which is based on a weighted average underlying index rate of 0.96% as of the date we acquired the securities and a weighted average margin of 1.80%.

Interest income for the current and prior year three month periods is net of \$112.6 million and \$30.8 million for the amortization of premium and discounts on our investment portfolio, respectively. Interest income for the current and prior year nine month periods is net of \$239.5 million and \$66.0 million, respectively, for the net amortization of premiums and discounts. The unamortized premium balance of our aggregate investment portfolio, including the unamortized cost basis of our interest-only securities and net of discounts, was \$1.9 billion and \$626.3 million as of September 30, 2011 and December 31, 2010, respectively.

#### Leverage

Our leverage as of September 30, 2011 and December 31, 2010 was 7.9 and 7.5 times our stockholders' equity, respectively. When adjusted for the net payable for agency securities purchased but not yet settled, our leverage ratio was 7.7 and 7.8 times our stockholders' equity as of September 30, 2011 and December 31, 2010, respectively. Our actual leverage will vary from time to time based on various factors, including our Manager's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity, over-collateralization levels required by lenders when we pledge agency securities to secure our borrowings and the current market value of our investment portfolio. In addition, certain of our master repurchase agreements and master swap agreements contain a restriction that prohibits our leverage from exceeding certain levels.

The table below presents our quarterly average and quarter end repurchase agreement and other debt balances outstanding and average leverage ratios for the nine month period ended September 30, 2011 and the 12 month period ended December 31, 2010 (dollars in thousands):

| Quarter Ended                     | Repurchase Agreements and Other Debt |                                  |                           | Average Daily Interest Rate on Amounts Outstanding | Average Interest Rate on Ending Amount Outstanding | Average Leverage <sup>(1)</sup> | Leverage as of Period End <sup>(2)</sup> | Leverage as of Period End, Net of Unsettled Trades <sup>(3)</sup> |
|-----------------------------------|--------------------------------------|----------------------------------|---------------------------|----------------------------------------------------|----------------------------------------------------|---------------------------------|------------------------------------------|-------------------------------------------------------------------|
|                                   | Average Daily Amount Outstanding     | Maximum Daily Amount Outstanding | Ending Amount Outstanding |                                                    |                                                    |                                 |                                          |                                                                   |
| September 30, 2011                | \$38,484,147                         | \$41,638,190                     | \$38,898,483              | 0.25%                                              | 0.28%                                              | 7.9:1                           | 7.9:1                                    | 7.7:1                                                             |
| June 30, 2011 <sup>(4)(5)</sup>   | \$28,668,011                         | \$33,566,899                     | \$33,566,899              | 0.25%                                              | 0.23%                                              | 7.6:1                           | 7.0:1                                    | 7.5:1                                                             |
| March 31, 2011 <sup>(4)(5)</sup>  | \$17,755,790                         | \$22,147,273                     | \$22,061,884              | 0.28%                                              | 0.28%                                              | 7.4:1                           | 6.6:1                                    | 7.6:1                                                             |
| December 31, 2010 <sup>(5)</sup>  | \$10,813,568                         | \$12,340,635                     | \$11,753,019              | 0.29%                                              | 0.31%                                              | 8.4:1                           | 7.5:1                                    | 7.8:1                                                             |
| September 30, 2010 <sup>(6)</sup> | \$7,241,783                          | \$8,050,221                      | \$8,050,221               | 0.28%                                              | 0.28%                                              | 8.5:1                           | 8.8:1                                    | 9.8:1                                                             |
| June 30, 2010                     | \$5,548,225                          | \$6,634,342                      | \$6,634,342               | 0.26%                                              | 0.28%                                              | 7.9:1                           | 8.4:1                                    | 8.2:1                                                             |

|                   |             |             |             |       |       |       |       |       |
|-------------------|-------------|-------------|-------------|-------|-------|-------|-------|-------|
| March 31,<br>2010 | \$3,787,583 | \$4,651,115 | \$4,651,115 | 0.22% | 0.21% | 6.5:1 | 7.6:1 | 7.9:1 |
|-------------------|-------------|-------------|-------------|-------|-------|-------|-------|-------|

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Average leverage during the period was calculated by dividing the daily weighted average repurchase agreements (1) and other debt outstanding, less amounts used to fund short-term investments in U.S. treasury securities, for the period by our average month-ended stockholders' equity for the period.

(2) Leverage as of period end was calculated by dividing the amount outstanding under our repurchase agreements and other debt by our stockholders' equity at period end.

Leverage as of period end, net of unsettled trades was calculated by dividing the sum of the amount outstanding (3) under our repurchase agreements, net liabilities and receivables for unsettled agency securities and other debt by our total stockholders' equity at period end.

Average leverage for the three months ended March 31 and June 30, 2011 was 8.2x and 8.3x, pro forma, when (4) average equity is adjusted to exclude the March and June 2011 follow-on equity offering that closed on March 25 and June 28, 2011, respectively.

(5) Average leverage for the period was higher than leverage as of period end because we had not fully invested net proceeds raised from follow-on equity offerings occurring late in the period.

Ending leverage for the period was higher than average leverage for the period because we increased our asset (6) positions through the use of additional leverage toward the end of the period in anticipation of a follow-on equity offering closing subsequent to period end.

#### Interest Expense and Cost of Funds

Interest expense was \$95.0 million and \$18.5 million for the current and prior year three month periods, respectively, and \$194.5 million and \$51.4 million for the current and prior year nine month periods, respectively. When including the cost of interest rate swaps not designated as hedges under GAAP, our total cost of funds was \$96.8 million and \$18.5 million for the current and prior year three month periods, respectively, and \$196.3 million and \$51.4 million for the current and prior year nine month periods, respectively. The year-over-year increase in our interest expense and cost of funds was the result of an increase in our average repurchase agreements and other debt outstanding, which was partially offset by a decline in the weighted average pay rate on our interest rate swap portfolio. The increase in interest expense and cost of funds for the current three month period was also impacted by an increase in our average ratio of interest rate swaps to repurchase agreements and other debt outstanding during the period (see Liquidity and Capital Resources for further discussion).

The tables below present information related to our cost of funds for the current and prior year three and nine month periods (dollars in thousands). Our average interest rate swaps outstanding included in the table below exclude forward starting swaps, which do not impact our interest expense and cost of funds until they commence accruing net interest settlements on their forward start dates. We enter into forward starting interest rate swaps based on a variety of factors, including our Manager's view of the forward yield curve and the timing of potential changes in short-term interest rates, time to deploy new capital, amount and timing of expirations of our existing interest swap portfolio and current and anticipated swap spreads. As of September 30, 2011, we had \$1.85 billion of forward starting swaps outstanding with forward start dates through December 2011, gross of \$0.3 billion of swaps set to expire through December 2011.

|                                                                                                             | For the three months ended<br>September 30, |                  |             |                  | For the nine months<br>ended September 30, |                  |             |                  |
|-------------------------------------------------------------------------------------------------------------|---------------------------------------------|------------------|-------------|------------------|--------------------------------------------|------------------|-------------|------------------|
|                                                                                                             | 2011                                        |                  | 2010        |                  | 2011                                       |                  | 2010        |                  |
|                                                                                                             | Amount                                      | % <sup>(1)</sup> | Amount      | % <sup>(1)</sup> | Amount                                     | % <sup>(1)</sup> | Amount      | % <sup>(1)</sup> |
| Debt and interest rate swaps                                                                                |                                             |                  |             |                  |                                            |                  |             |                  |
| Average repurchase agreements and other debt outstanding <sup>(3)</sup>                                     | \$38,484,147                                | 100 %            | \$7,241,783 | 100 %            | \$28,354,578                               | 100 %            | \$5,536,394 | 100 %            |
| Average interest rate swaps outstanding - designated as hedges under GAAP <sup>(4)</sup>                    | \$18,811,957                                | 49 %             | \$3,090,761 | 43 %             | \$12,532,784                               | 44 %             | \$2,616,667 | 47 %             |
| Average interest rate swaps outstanding - designated and non-designated as hedges under GAAP <sup>(4)</sup> | \$19,937,500                                | 52 %             | \$3,096,196 | 43 %             | \$13,077,839                               | 46 %             | \$2,627,656 | 47 %             |
| Weighted average pay rate on interest rate swaps - designated and non-designated under GAAP <sup>(4)</sup>  | 1.63                                        | %                | 1.98        | %                | 1.66                                       | %                | 2.00        | %                |
|                                                                                                             | Amount                                      | % <sup>(2)</sup> | Amount      | % <sup>(2)</sup> | Amount                                     | % <sup>(2)</sup> | Amount      | % <sup>(2)</sup> |

## Cost of funds

## Interest expense:

|                                                                                                                |          |        |          |        |           |        |          |        |
|----------------------------------------------------------------------------------------------------------------|----------|--------|----------|--------|-----------|--------|----------|--------|
| Repurchase agreements and other debt                                                                           | \$23,982 | 0.25 % | \$5,180  | 0.28 % | \$54,003  | 0.25 % | \$10,775 | 0.26 % |
| Periodic interest settlements of interest rate swaps designated as hedges under GAAP, net                      | 71,054   | 0.73 % | 13,351   | 0.73 % | 140,497   | 0.66 % | 34,336   | 0.83 % |
| Amortization of termination fees on interest rate swaps designated as hedges under GAAP                        | —        | — %    | —        | — %    | —         | — %    | 6,278    | 0.15 % |
| Total interest expense                                                                                         | 95,036   | 0.98 % | 18,531   | 1.02 % | 194,500   | 0.92 % | 51,389   | 1.24 % |
| Realized loss on periodic interest settlements of interest rate swaps not designated as hedges under GAAP, net | 1,773    | 0.02 % | —        | — %    | 1,773     | 0.01 % | —        | — %    |
| Total cost of funds                                                                                            | \$96,809 | 1.00 % | \$18,531 | 1.02 % | \$196,273 | 0.93 % | \$51,389 | 1.24 % |

(1) Percent of the average repurchase agreements and other debt outstanding for the period.

(2) Annualized percent of the average repurchase agreements and other debt outstanding for the period.

(3) Average repurchase agreement and other debt represents their daily weighted average balances, less amounts used to fund short-term investments in U.S. treasury securities.

(4) Average interest rates swaps outstanding exclude forward starting interest rates swaps not in effect during the periods presented.

Gain on Sale of Agency Securities, Net

The following table is a summary of our net gain on sale of agency securities for the current and prior year periods (in thousands):

|                                                     | For the three months ended<br>September 30, |                | For the nine months ended<br>September 30, |                |
|-----------------------------------------------------|---------------------------------------------|----------------|--------------------------------------------|----------------|
|                                                     | 2011                                        | 2010           | 2011                                       | 2010           |
| Agency securities sold, at cost                     | \$(14,045,636 )                             | \$(2,172,978 ) | \$(26,429,464 )                            | \$(6,914,764 ) |
| Proceeds from agency securities sold <sup>(1)</sup> | 14,308,404                                  | 2,197,543      | 26,790,344                                 | 6,996,322      |
| Net gains on sale of agency securities              | \$262,768                                   | \$24,565       | \$360,880                                  | \$81,558       |
| Gross gains on sale of agency securities            | \$267,573                                   | \$26,333       | \$376,806                                  | \$87,714       |
| Gross losses on sale of agency securities           | (4,805 )                                    | (1,768 )       | (15,926 )                                  | (6,156 )       |
| Net gains on sale of agency securities              | \$262,768                                   | \$24,565       | \$360,880                                  | \$81,558       |

(1) Proceeds include cash received during the period, plus receivable for agency securities sold during the period as of period end.

Sales of securities are driven by our Manager's execution of our active portfolio management strategy. Our strategy for the periods presented was largely focused on repositioning our portfolio towards securities with attributes our Manager believes reduce the level of prepayment risk and overall exposure to interest rate risk in light of current and anticipated interest rates, federal government programs, general economic conditions and other factors. During the three month period ended September 30, 2011, we sold holdings of higher coupon securities and reinvested the sales' proceeds into lower coupon securities backed by loans our Manager believes have more favorable prepayment attributes relative to the current economic environment, including the general decline in interest rates as of the end of the current period and anticipated potential changes to HARP, which were subsequently announced by the FHFA on October 24, 2011. We also sold a substantial amount of securities that our Manager believed could have been negatively impacted had the FHFA made different changes to the HARP program than those recently outlined. Sales of securities during the prior year periods were largely driven by our Manager's intent of reinvesting sales proceeds into assets with more favorable involuntary prepayment attributes in anticipation of increased levels of GSE buyouts of delinquent mortgage loans from their outstanding mortgage pools.

Gain (loss) on Derivative Instruments and Other Securities, Net

The following table is a summary of our gain (loss) on derivative instruments and other securities, net for current and prior year periods (in thousands):

|                                                                                         | For the three months<br>ended September 30, |             | For the nine months<br>ended September 30, |              |
|-----------------------------------------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|--------------|
|                                                                                         | 2011                                        | 2010        | 2011                                       | 2010         |
| Realized loss on periodic interest settlements of interest rate swaps, net              | \$ (1,773                                   | ) \$ —      | \$ (1,773                                  | ) \$ —       |
| Other realized (loss) gain on derivative instruments and other securities:              |                                             |             |                                            |              |
| Purchase of TBAs and forward settling agency securities                                 | 60,984                                      | (9,157      | ) 97,896                                   | (12,396      |
| Sale of TBAs and forward settling agency securities                                     | (154,695                                    | ) —         | (265,975                                   | ) —          |
| Interest rate payer swaptions                                                           | (8,346                                      | ) —         | (5,697                                     | ) —          |
| Interest rate receiver swaptions                                                        | —                                           | 9,298       | (369                                       | ) 9,056      |
| Interest rate swaps not designated as hedges                                            | (1,120                                      | ) (1,014    | ) (6,200                                   | ) (2,125     |
| U.S. Treasury securities                                                                | 5,655                                       | 372         | 33,967                                     | 1,815        |
| Short sales of U.S. Treasury securities                                                 | (72,919                                     | ) (330      | ) (87,679                                  | ) (330       |
| Markit IOS Index total return swaps                                                     | (2,741                                      | ) —         | 10,091                                     | —            |
| U.S. Treasury futures                                                                   | (8                                          | ) 95        | 239                                        | 94           |
| Put options                                                                             | —                                           | —           | 1,133                                      | (328         |
| Total other realized loss on derivative instruments and other securities, net           | (173,190                                    | ) (736      | ) (222,594                                 | ) (4,214     |
| Unrealized (loss) gain on derivative instruments and trading securities: <sup>(1)</sup> |                                             |             |                                            |              |
| Purchase of TBAs and forward settling agency securities                                 | 86,095                                      | 1,395       | 17,527                                     | (3,810       |
| Sale of TBAs and forward settling agency securities                                     | (65,412                                     | ) —         | (23,560                                    | ) —          |
| Interest-only and principal only strips                                                 | (27,469                                     | ) (865      | ) (24,408                                  | ) (7,802     |
| Interest rate payer swaptions                                                           | (24,388                                     | ) (2,301    | ) (53,285                                  | ) (1,740     |
| Interest rate receiver swaptions                                                        | —                                           | —           | —                                          | (575         |
| Interest rate swaps not designated as hedges                                            | (899                                        | ) (1,201    | ) (1,442                                   | ) (1,201     |
| U.S. Treasury securities                                                                | (668                                        | ) —         | (668                                       | ) —          |
| Short sales of U.S. Treasury securities                                                 | (19,099                                     | ) —         | (4,144                                     | ) —          |
| Markit IOS total return swaps                                                           | 3,589                                       | —           | 2,649                                      | —            |
| U.S. Treasury futures                                                                   | 1,708                                       | —           | 1,708                                      | —            |
| Hedge ineffectiveness on interest rate swaps                                            | —                                           | (25         | ) —                                        | (338         |
| Total unrealized loss on derivative instruments and other securities, net               | (46,543                                     | ) (2,997    | ) (85,623                                  | ) (15,466    |
| Total loss on derivative instruments and trading securities, net                        | \$ (221,506                                 | ) \$ (3,733 | ) \$ (309,990                              | ) \$ (19,680 |

(1) Unrealized gain (loss) from derivatives and trading securities includes reversals of prior period amounts for settled or expired derivatives and trading securities.

The year-over-year increases in net losses from derivatives and other securities were due to an increase in the size of our investment portfolio coupled with an increase in our use of other supplemental hedging strategies entered into to manage the potential adverse impact of near term changes in interest rates on our net asset value and future cash flows. We invest in other supplemental hedges, in addition to our use of interest rate swap agreements that are intended to hedge against longer-term increases in interest rates, based on a variety of factors, including our Manager's view of how our existing portfolio of agency securities will perform under different interest rate scenarios and the need to hedge against potential near-term changes in interest rates. The intended purpose of the other supplemental hedges held during the current three month period was to hedge against potential near-term increases in interest rates. Consequently, the net losses from our supplemental hedges for the current three month period were driven by a general decline in interest rates during the period. For further details regarding our derivatives and related hedging

activity please refer to Notes 3 and 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q.  
Management Fees and General and Administrative Expenses

We pay our Manager a base management fee payable monthly in arrears in amount equal to one twelfth of 1.25% of our Equity. Our Equity is defined as our month-end stockholders' equity, adjusted to exclude the effect of any unrealized gains or losses included in either retained earnings or OCI, each as computed in accordance with GAAP. There is no incentive compensation payable to our Manager pursuant to the management agreement. We incurred management fees of \$15.6 million and \$2.7 million for the three month periods ended September 30, 2011 and 2010, respectively, and \$36.5 million and \$6.8

million for the nine month periods ended September 30, 2011 and 2010, respectively.

General and administrative expenses were \$5.8 million and \$1.9 million for the three month periods ended September 30, 2011 and 2010, respectively, and \$13.0 million and \$5.4 million for the nine month periods ended September 30, 2011 and 2010, respectively. Our general and administrative expenses primarily consist of prime brokerage fees, information technology costs, allocation of overhead expenses from our Manager, accounting fees, legal fees, Board of Director fees and insurance expenses.

Our total management fee and general and administrative expenses as a percentage of our average stockholders' equity on an annualized basis declined year-over-year to 1.75% from 2.15% for the current and prior three month period, respectively, and to 1.79% from 2.28% for the current and prior nine month period, respectively, due to improved operating leverage.

#### Dividends

For the current and prior year periods, we declared quarterly dividends of \$1.40 per share. As a REIT, we are required to distribute annually 90% of our taxable income to maintain our status as a REIT and all of our taxable income to avoid Federal, state and local corporate income taxes. We can treat dividends declared by September 15 and paid by December 31 as having been a distribution of our taxable income for our prior tax year. As of September 30, 2011, we have declared or paid all of our taxable income for the 2010 tax year and we have an estimated \$156.3 million (or \$0.85 per share) of undistributed taxable income related to our 2011 tax year, net of the September 30, 2011 dividend payable of \$257.1 million. Income as determined under GAAP differs from income as determined under tax rules because of both temporary and permanent differences in income and expense recognition. Examples include temporary differences related to unrealized gains and losses on derivative instruments and other securities that are recognized in income for GAAP but are excluded from taxable income until realized or settled, temporary differences in the CPR used to amortize premiums or accrete discounts, temporary differences related to timing of the recognition of hedge ineffectiveness, permanent and temporary differences related to the timing and amount recognized for stock-based compensation and permanent differences for excise tax expense.

## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of funds are borrowings under master repurchase agreements, equity offerings, asset sales and monthly principal and interest payments on our investment portfolio. Because the level of our borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on the balance sheet is significantly less important than the potential liquidity available under our borrowing arrangements. We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings, maintenance of any margin requirements and the payment of cash dividends as required for our continued qualification as a REIT. To qualify as a REIT, we must distribute annually at least 90% of our taxable income. To the extent that we annually distribute all of our taxable income in a timely manner, we will generally not be subject to federal and state income taxes. We currently expect to distribute all of our taxable income in a timely manner so that we are not subject to Federal and state income taxes. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital from operations.

#### Equity Capital Raising Activities

To the extent we raise additional equity capital through follow-on equity offerings, through our Controlled Equity Offering<sup>SM</sup> program or under our dividend reinvestment and direct stock purchase plan, we currently anticipate using cash proceeds from such transactions to purchase additional agency securities, to make scheduled payments of principal and interest on our repurchase agreements and for other general corporate purposes. There can be no assurance, however, that we will be able to raise additional equity capital at any particular time or on any particular terms.

#### Equity Offerings

During the nine months ended September 30, 2011, we completed three follow-on public offerings of shares of our common stock summarized in the table below (in thousands, except per share amounts):

| Public Offering | Price Received<br>Per Share <sup>(1)</sup> | Shares | Net Proceeds <sup>(2)</sup> |
|-----------------|--------------------------------------------|--------|-----------------------------|
|-----------------|--------------------------------------------|--------|-----------------------------|

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|                           |         |         |             |
|---------------------------|---------|---------|-------------|
| January 2011              | \$28.00 | 26,910  | \$719,250   |
| March 2011 <sup>(3)</sup> | \$27.72 | 32,200  | 892,233     |
| June 2011 <sup>(3)</sup>  | \$27.56 | 49,680  | 1,368,848   |
| Total                     |         | 108,790 | \$2,980,331 |

(1) Price received per share is gross of underwriters' discount, if applicable.

(2) Net proceeds are net of the underwriters' discount, if applicable, and other offering costs.

Shares of our common stock were sold to underwriters, who sold the shares in one or more transactions on the (3) Nasdaq Global Select Market, in the over-the-counter market, through negotiated transactions or otherwise at market prices prevailing at the time of sale.

In November 2011, we completed a public offering in which 40.5 million shares of our common stock were sold to the underwriters at a price of \$27.36 per share. The underwriters in the offering sold the shares of our common stock in one or more transactions on the Nasdaq Global Select Market, in the over-the-counter market, through negotiated transactions or otherwise at market prices prevailing at the time of sale. Upon completion of the offering we received proceeds, net of offering expenses, of approximately \$1.1 billion.

#### Controlled Equity Offering<sup>SM</sup> Program

We have a sales agreement with an underwriter to, from time-to-time, publicly offer and sell up to 15 million shares of our common stock in privately negotiated and/or at-the-market transactions. During the three month period ended September 30, 2011, we sold 5.1 million shares of our common stock under the sales agreement at an average offering price of \$29.07 per share for proceeds, net of the underwriter's discount and other program costs, of \$146.9 million. During the nine month period ended September 30, 2011, we sold 9.4 million shares of our common stock under the sales agreement at an average offering price of \$29.23 per share for proceeds, net of the underwriter's discount and other program costs, of \$273.0 million. As of September 30, 2011, 1.2 million shares of our common stock remain available for issuance under the sales agreement.

#### Dividend Reinvestment and Direct Stock Purchase Plan

We sponsor a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of our common stock by reinvesting some or all of the cash dividends received on shares of our common stock. Stockholders may also make optional cash purchases of shares of our common stock subject to certain limitations detailed in the plan prospectus. During the three month period ended September 30, 2011, there were no shares issued under the plan. During the nine month period ended September 30, 2011, we issued 0.5 million shares under the plan for net cash proceeds of \$14.9 million. As of September 30, 2011, there were 4.7 million shares available for issuance under the plan.

#### Debt Capital

As part of our investment strategy, we borrow against our investment portfolio pursuant to master repurchase agreements. We expect that our borrowings pursuant to repurchase transactions under such master repurchase agreements generally will have maturities ranging up to one year. As of September 30, 2011, borrowings under repurchase arrangements secured by agency securities totaled \$38.8 billion, other debt associated with a structured transaction accounted for as a financing transaction totaled \$0.1 billion and net receivables for agency securities not yet settled was \$1.0 billion. Our leverage ratio was 7.7 times the amount of our stockholders' equity as of September 30, 2011, including our total borrowings, net of receivables for agency securities not yet settled.

Our cost of borrowings under master repurchase agreements generally corresponds to LIBOR plus or minus a margin. As of September 30, 2011, the weighted average interest rate on our repurchase agreements was 0.28%, which reflects an increase from 0.23% as of June 30, 2011, as a result of extending the average original term of our repurchase agreements to 57 days as of September 30, 2011 from 47 days as of June 30, 2011. During the three month period ended September 30, 2011, we elected to discontinue accounting for our interest rate swaps as designated cash-flow hedges under GAAP in order to allow us greater flexibility in setting the maturity of our repurchase agreements and, thereby, enabling us to opportunistically extend the terms of our repurchase agreements to reduce the "roll risk" associated with maturing repurchase agreements. Please refer to Notes 3 and 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q for further details regarding our discontinuation of hedge accounting.

To limit our exposure to counterparty credit risk, we diversify our funding across multiple counterparties and by counterparty region. As of September 30, 2011, we had master repurchase agreements with 29 financial institutions, subject to certain conditions, located throughout North America, Europe and Asia. As of September 30, 2011, less than 4% of our stockholders equity was at risk with any one counterparty, with the top five counterparties representing less than 15% of our stockholders equity. The table below includes a summary of our repurchase agreement funding

by number of counterparties and counterparty region as of September 30, 2011. For further details regarding our borrowings under repurchase agreements and other debt as of September 30, 2011, please refer to Note 5 to our consolidated financial statements in this Quarterly Report on Form 10-Q.

| Counter-Party Region | As of September 30, 2011  |                                         |
|----------------------|---------------------------|-----------------------------------------|
|                      | Number of Counter-Parties | Percent of Repurchase Agreement Funding |
| North America        | 15                        | 48%                                     |
| Europe               | 9                         | 23%                                     |
| Asia                 | 5                         | 29%                                     |
|                      | 29                        | 100%                                    |

Amounts available to be borrowed under our repurchase agreements are dependent upon lender collateral requirements and the lender's determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates, credit quality and liquidity conditions within the investment banking, mortgage finance and real estate industries. Under the repurchase agreements, we may be required to pledge additional assets to the repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a margin call), which may take the form of additional securities or cash. Similarly, if the estimated fair value of investment securities increases due to changes in the market interest rates, lenders may release collateral back to us. Specifically, margin calls would result from a decline in the value of the agency securities securing our repurchase agreements and prepayments on the mortgages securing such agency securities. As of September 30, 2011, we have met all margin requirements. We had unrestricted cash and cash equivalents of \$984.4 million and unpledged agency securities of \$1.8 billion, excluding net unsettled purchases and sales of agency securities, available to meet margin calls on our repurchase agreements and derivative instruments as of September 30, 2011.

Although we believe that we will have adequate sources of liquidity available to us through repurchase agreement financing to execute our business strategy, there can be no assurances that repurchase agreement financing will be available to us upon the maturity of our current repurchase agreements to allow us to renew or replace our repurchase agreement financing on favorable terms or at all. If our repurchase agreement lenders default on their obligations to resell the underlying agency securities back to us at the end of the term, we could incur a loss equal to the difference between the value of the agency securities and the cash we originally received. On October 31, 2011, MF Global Holdings, Ltd., an affiliate of MF Global Inc., a counterparty to one of our master repurchase agreements, filed for Chapter 11 in a U.S. bankruptcy court. As of October 31, 2011, we had less than \$1.0 million of counterparty exposure with regard to MF Global Inc.

We maintain an interest rate risk management strategy under which we use derivative financial instruments to manage the adverse impact of interest rates changes on the value of our investment portfolio as well as our cash flows. In particular, we attempt to mitigate the risk of the cost of our short-term variable rate liabilities increasing at a faster rate than the earnings of our long-term assets during a period of rising interest rates. The principal derivative instruments that we use are interest rate swaps, supplemented with the use of interest rate swaptions, TBA agency securities, options, futures and other instruments.

We use interest rate swap agreements to effectively lock in fixed rates on a portion of our short-term borrowings because longer-term committed borrowings are not available at attractive terms. We have entered into interest rate swap agreements to attempt to mitigate the risk of the cost of our short-term variable rate liabilities rising during a period of rising interest rates, thereby compressing the net spreads that we earn on our long-term fixed-rate assets. As of September 30, 2011, we had \$26.95 billion of interest rate swaps outstanding. Our ratio of interest rates swaps outstanding to repurchase agreements and other debt outstanding, including the net payable/receivable for unsettled trades, increased to 71% as of September 30, 2011 from 62% as of June 30, 2011. In light of the historically low level of interest rate swap pay rates observed during the quarter, coupled with the fact that the variable rate we receive on our pay fixed interest rates swaps is naturally bound by a floor of no less than 0.0% (meaning swap values are near their lowest levels), we increased our hedge ratio and concentrated our new interest rate swap activity on intermediate and longer-term swaps. The new interest rate swap agreements entered into during the quarter had a weighted average term of 4.0 years. Despite extending the term of our interest rate swaps, the average pay rate on our interest rate swap portfolio decreased to 1.58% (or 1.33% net of the receive rate) as of September 30, 2011 from 1.68% (or 1.49% net of the receive rate) as of June 30, 2011. Including the impact of interest rate swaps in effect of \$25.1 billion as of

September 30, 2011, plus \$1.85 billion of forward starting swaps starting within three months of September 30, 2011, less \$0.3 billion of swaps set to expire within three months of September 30, 2011, our total weighted average interest expense and cost of funds was 1.24% as of September 30, 2011. Please refer to Note 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q for further details regarding our outstanding interest rate swaps as of September 30, 2011 and related activity for the third quarter 2011.

Off-Balance Sheet Arrangements

As of September 30, 2011, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of September 30, 2011, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

#### FORWARD-LOOKING STATEMENTS

This document contains “forward-looking statements” (within the meaning of the Private Securities Litigation Reform Act of 1995) that inherently involve risks and uncertainties. Our actual results and liquidity can differ materially from those anticipated in these forward-looking statements because of changes in the level and composition of our investments and other factors. These factors may include, but are not limited to, changes in general economic conditions, the availability of suitable investments from both an investment return and regulatory perspective, the availability of new investment capital, fluctuations in interest rates and levels of mortgage prepayments, deterioration in credit quality and ratings, the effectiveness of risk management strategies, the impact of leverage, liquidity of secondary markets and credit markets, increases in costs and other general competitive factors.

#### ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risks that we are exposed to are interest rate risk, prepayment risk, spread risk, liquidity risk, extension risk and inflation risk.

##### Interest Rate Risk

Interest rate risk is 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 our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our interest-earning assets and interest bearing liabilities.

Changes in the level of interest rates can also affect the rate of prepayments of our securities and the value of the agency securities that constitute our investment portfolio, which affects our ability to realize gains from the sale of these assets and impacts our ability and the amount that we can borrow against these securities.

We may utilize a variety of financial instruments in order to limit the effects of changes in interest rates on our operations, including interest rate swap agreements, interest rate swaptions, interest rate cap or floor contracts and futures or forward contracts. We may also purchase or short TBA, U.S. Treasury securities and U.S. Treasury futures contracts, purchase or write put or call options on TBA securities or we may invest in other types of mortgage derivative securities, such as interest-only securities, and synthetic total return swaps, such as the Markit IOS Index. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of our common stock and that the losses may exceed the amount we invested in the instruments. Our profitability and the value of our investment portfolio (including derivatives used for hedging purposes) may be adversely affected during any period as a result of changing interest rates including resulting changes in forward yield curves. The following table quantifies the estimated changes in net interest income and investment portfolio value should interest rates go up or down by 50 and 100 basis points, assuming the yield curves of the rate shocks will be parallel to each other and the current yield curve. These estimates were compiled using a combination of third-party services, market data and internal models. All changes in income and value are measured as percentage changes from the projected net interest income and investment portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates as of September 30, 2011. Given the low level of interest rates, we also apply a floor of 0% for all anticipated interest rates included in our assumptions, such that any hypothetical interest rate decrease would have a limited positive impact on our funding costs beyond a certain level. However, because estimated prepayment speeds are unaffected by this floor, it is expected that an increase in our prepayment speeds as a result of a hypothetical interest rate decrease would result in an acceleration of our premium amortization and could

result in reinvestment of such prepaid principal into lower yielding assets.

Actual results could differ materially from estimates, especially in the current market environment. The accuracy of the projected agency securities prices relies on assumptions that define specific agency securities spreads and varying prepayment assumptions at projected interest rate levels. To the extent that these estimates or other assumptions do not hold true, which is likely in a period of high price volatility, actual results will likely differ materially from projections and could be larger or

smaller than the estimates in the table below. Moreover, if different models were employed in the analysis, materially different projections could result. In addition, the table below also does not include the impact of leverage, which generally has the effect of increasing the impact of the percentage change in projected portfolio value on stockholders equity by a factor of leverage plus one. Lastly, while the tables below reflect the estimated impact of interest rate increases and decreases on a static portfolio, we may from time to time sell any of our agency securities as a part of our overall management of our investment portfolio.

| Change in Interest Rate | Percentage Change<br>in Projected Net<br>Interest Income | Percentage Change<br>in Projected<br>Portfolio Value,<br>with Effect of<br>Derivatives |
|-------------------------|----------------------------------------------------------|----------------------------------------------------------------------------------------|
| +100 Basis Points       | -9.8%                                                    | -0.8%                                                                                  |
| +50 Basis Points        | -7.7%                                                    | -0.2%                                                                                  |
| -50 Basis Points        | -9.7%                                                    | -0.2%                                                                                  |
| -100 Basis Points       | -17.5%                                                   | -0.8%                                                                                  |

#### Prepayment Risk

Premiums and discounts associated with the purchase of agency securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method. Furthermore, changes to the GSE's underwriting standards, further modifications to existing U.S. government sponsored programs such as HARP, or the implementation of new programs could materially impact prepayment speeds. In addition, GSE buyouts of loans in imminent risk of default, loans that have been modified, or loans that have defaulted will generally be reflected as prepayments on agency securities and also increase the uncertainty around these estimates. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate published prepayment data for similar agency securities, market consensus and current market conditions. If the actual prepayment experienced differs from our estimate of prepayments, we will be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

#### Spread Risk

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in OCI pursuant to ASC 320. As of September 30, 2011, the fair value of these securities was \$42.0 billion. When the spread between the yield on our agency securities and U.S. Treasury securities or swap rates widens, this could cause the value of our agency securities to decline, creating what we refer to as spread risk. The spread risk associated with our agency securities and the resulting fluctuations in fair value of these securities can occur independent of interest rates and may relate to other factors impacting the mortgage and fixed income markets such as liquidity or changes in required rates of return on different assets.

#### Liquidity Risk

The primary liquidity risk for us arises from financing long-term assets with shorter-term borrowings in the form of repurchase agreements. Our assets that are pledged to secure repurchase agreements are high-quality agency securities and cash. As of September 30, 2011, we had unrestricted cash and cash equivalents of \$984.4 million and unpledged agency securities of \$1.8 billion available to meet margin calls on our repurchase agreements, derivative instruments and for other corporate purposes. However, should the value of our agency securities pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. As such, we cannot assure that we will always be able to renew (or roll) our repurchase agreements. In addition, our counterparties have the option to increase our haircuts (margin requirements) on the assets we pledge against repurchase agreements, thereby reducing the amount that can be borrowed against an asset even if they agree to renew or roll the repurchase agreement. Significantly higher haircuts can reduce our ability to leverage our portfolio or even force us to sell assets, especially if correlated with asset price declines or faster prepayment rates on our assets.

#### Extension Risk

The projected weighted-average life and the duration (or interest rate sensitivity) of our investments is based on our Manager's assumptions regarding the rate at which the borrowers will prepay the underlying mortgage loans. In general, we use interest rate swaps and swaptions to help manage our funding cost on our investments in the event that interest rates rise. These swaps (or swaptions) allow us to reduce our funding exposure on the notional amount of the swap for a specified period of time by agreeing to pay a fixed-rate in exchange for receiving a floating rate that generally tracks our financing costs under our

repurchase agreements.

However, if prepayment rates decrease in a rising interest rate environment, the average life or duration of our fixed-rate assets or the fixed-rate portion of the ARMs or other assets generally extends. This could have a negative impact on our results from operations, as our interest rate swap maturities are fixed and will, therefore, cover a smaller percentage of our funding exposure on our mortgage assets to the extent that their average lives increase due to slower prepayments. This situation may also cause the market value of our agency securities collateralized by fixed rate mortgages or hybrid ARMs to decline by more than otherwise would be the case while most of our hedging instruments (with the exception of short TBA mortgage positions, interest-only securities, Markit IOS Index total return swaps and certain other supplemental hedging instruments) would not receive any offsetting gains. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could cause us to incur realized losses.

#### Inflation Risk

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Further, our consolidated financial statements are prepared in accordance with GAAP and our distributions are determined by our Board of Directors based primarily by our net income as calculated for income tax purposes. In each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

#### ITEM 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act of 1934, as amended (the “Exchange Act”) reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of “disclosure controls and procedures” as promulgated under the Exchange Act and the rules and regulations there under. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2011. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

##### Changes in Internal Controls over Financial Reporting

There have been no changes in our “internal control over financial reporting” (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the three month or nine month period ended September 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### PART II.—OTHER INFORMATION

##### Item 1. Legal Proceedings

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of September 30, 2011, we had no legal proceedings.

##### Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010, except as described below.

You should carefully consider the risks described below and all other information contained in this interim report on Form 10-Q, including our interim consolidated financial statements and the related notes thereto before making a decision to purchase our securities. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us, or not presently deemed material by us, may also impair our operations and performance.

If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. If that happens, the trading price of our securities could decline, and you may lose all or part of your investment.

Loss of our exemption from regulation pursuant to the Investment Company Act would adversely affect us.

We conduct our business so as not to become regulated as an investment company under the Investment Company Act in reliance on the exemption provided by Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires that: (i) at least 55% of our investment portfolio consist of "mortgages and other liens on and interests in real estate," or "qualifying real estate interests," and (ii) at least 80% of our investment portfolio consist of qualifying real estate interests plus "real estate-related assets." In satisfying this 55% requirement, we may treat agency securities issued with respect to an underlying pool of mortgage loans in which we hold all of the certificates issued by a pool, or a "whole pool," as qualifying real estate interests. Therefore, the agency securities and any other mortgage-related assets that we acquire are limited by the provisions of the Investment Company Act and the rules and regulations promulgated thereunder. If the SEC determines that any of these securities are not qualifying real estate interests or real estate-related assets, adopts a contrary interpretation with respect to these securities or otherwise believes we do not satisfy the above exceptions, we could be required to restructure our activities or sell certain of our assets. We may be required at times to adopt less efficient methods of financing certain of our agency securities and we may be precluded from acquiring certain types of higher yielding agency securities. The net effect of these factors would be to lower our net interest income. If we fail to qualify for an exemption from registration as an investment company or an exclusion from the definition of an investment company, our ability to use leverage would be substantially reduced. Our business will be materially and adversely affected if we fail to qualify for this exemption from regulation from the Investment Company Act.

The SEC recently solicited public comment on a wide range of issues relating to Section 3(c)(5)(C), including the nature of the assets that qualify for purposes of the exemption and whether mortgage REITs should be regulated in a manner similar to investment companies. There can be no assurance that the laws and regulations governing the Investment Company Act status of REITs, including the guidance of the Division of Investment Management of the SEC regarding this exemption, will not change in a manner that adversely affects our operations. If we or our subsidiaries fail to maintain an exception or exemption from the Investment Company Act, we could, among other things, be required either to (a) change the manner in which we conduct our operations to avoid being required to register as an investment company, (b) effect sales of our assets in a manner that, or at a time when, we would not otherwise choose to do so, or (c) register as an investment company (which, among other things, would require us to comply with the leverage constraints applicable to investment companies), any of which could negatively affect the value of our common stock, the sustainability of our business model, and our ability to make distributions, which could have an adverse effect on our business and the market price for shares of our common stock.

We have no employees and our Manager is responsible for making all of our investment decisions. Certain of our Manager's officers are employees of American Capital and are not required to devote any specific amount of time to our business and each of them may provide their services to American Capital, its affiliates and sponsored investment vehicles, which could result in conflicts of interest.

Because we have no employees, our Manager is responsible for making all of our investment decisions. Certain of our and our Manager's officers are employees of American Capital or its affiliates and these persons do not devote their time exclusively to us. Our Manager's investment committee consists of Malon Wilkus, John R. Erickson, Samuel A. Flax and Thomas A. McHale, each of whom is an officer of American Capital and has significant responsibilities to American Capital and certain of its portfolio companies, affiliated entities or managed funds. Gary Kain is our President and Chief Investment Officer and also serves as the President and Chief Investment Officer of American Capital Mortgage Investment Corp., a fund managed by a subsidiary of the parent company of our Manager, for which he has significant responsibilities. Gary Kain also serves as the President and a member of the parent company of our Manager, and he may have other significant responsibilities in the future related to new funds that are managed by the parent company of our Manager or affiliated entities of our Manager.

American Capital has agreed that so long as our Manager or an affiliate of American Capital continues to manage our company, it will not sponsor another investment vehicle that invests predominantly in whole pool agency securities.

This restriction does not prevent American Capital or an affiliate of American Capital from investing in or sponsoring an investment vehicle that targets investments in agency securities so long as those investments are not predominately whole pool agency securities, and, as a result, American Capital or an affiliate of American Capital may compete with us. During August 2011, American Capital and its affiliates sponsored the initial public offering of, and invested in, American Capital Mortgage Investment Corp., an investment vehicle that makes significant investments in agency securities, including whole pool agency securities. Our Manager and its employees are not restricted from participating in the management of such an entity.

Our Board of Directors has adopted investment guidelines that require that any investment transaction between us and American Capital or any affiliate of American Capital receive the prior approval of a majority of our independent directors.

However, this policy does not eliminate the conflicts of interest that our and our Manager's officers will face in making investment decisions on behalf of American Capital, any other American Capital-sponsored investment vehicles and us. Further, we do not have any agreement or understanding with American Capital that would give us any priority over American Capital, any of its affiliates, or any such American Capital-sponsored investment vehicle in opportunities to invest in agency securities. Accordingly, we may compete for access to the benefits that we expect our relationship with our Manager and American Capital to provide.

We may change our policies at any time without stockholder approval, including our investment policy, which may adversely affect our financial condition, results of operations, the market price of our common stock or our ability to pay dividends or distributions.

Our Board of Directors and management determine all of our policies, including our investment, financing and distribution policies. They may amend or revise these policies at any time without a vote of our stockholders. Changes in our investment guidelines, including a change that would permit us to invest in non-agency securities, could increase the risk profile of our investment portfolio. If that were to happen, non-agency mortgage-backed securities would be subject to all of the risks of the respective underlying mortgage loans, including delinquency and foreclosure, which could result in significant losses to us. Changes to our investment and other policies could also adversely affect our financial condition, results of operations, the market price of our common stock or our ability to pay dividends or distributions.

The market price of our common stock may fluctuate significantly.

The market price and marketability of shares of our securities may from time to time be significantly affected by numerous factors, including many over which we have no control and that may not be directly related to us. These factors include the following:

- price and volume fluctuations in the stock market from time to time, which are often unrelated to the operating performance of particular companies;
- significant volatility in the market price and trading volume of securities of REITs or other companies in our sector, which is not necessarily related to the operating performance of these companies;
- changes in regulatory policies, tax laws and financial accounting and reporting standards, particularly with respect to REITs, or applicable exemptions from the Investment Company Act of 1940, as amended;
- actual or anticipated changes in our dividend policy and earnings or variations in operating results;
- any shortfall in revenue or net income or any increase in losses from levels expected by securities analysts;
- issuances of additional equity securities;
- additions or departures of key management personnel, or changes in our relationship with our Manager and American Capital;
- decreases in our net asset value per share;
- general economic trends and other external factors; and
- loss of major repurchase agreement providers.

Fluctuations in the trading price of our common stock may adversely affect the liquidity of the trading market for our common stock and, in the event that we seek to raise capital through future equity financings, our ability to raise such equity capital.

#### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

#### Item 3. Defaults Upon Senior Securities

None.

#### Item 4. Removed and Reserved

#### Item 5. Other Information

None.

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Item 6. Exhibits

(a) Exhibits:

Exhibit No. Description

- |      |                                                                                                                                                                                                                                                                                             |
|------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| *3.1 | American Capital Agency Corp. Amended and Restated Certificate of Incorporation, as amended, incorporated herein by reference to Exhibit 3.1 of Form 10-Q for the quarter ended June 30, 2011 (File No. 001-34057), filed August 9, 2011.                                                   |
| *3.2 | American Capital Agency Corp. Second Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.1 of Form 8-K (File No. 001-34057), filed July 26, 2011.                                                                                                                    |
| *4.1 | Instruments defining the rights of holders of securities: See Article IV of our Amended and Restated Certificate of Incorporation, as amended, incorporated herein by reference to Exhibit 3.1 of Form 10-Q for the quarter ended June 30, 2011 (File No. 001-34057), filed August 9, 2011. |
| *4.2 | Instruments defining the rights of holders of securities: See Article VI of our Second Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.1 of Form 8-K (File No. 001-34057), filed July 26, 2011.                                                                  |
| *4.3 | Form of Certificate for Common Stock, incorporated herein by reference to Exhibit 4.1 to Amendment No. 4 to the Registration Statement on Form S-11 (Registration No. 333-149167), filed May 9, 2008.                                                                                       |
| 10.1 | Assignment and Amendment Agreement, dated as of July 29, 2011, among American Capital Agency Management, LLC, American Capital AGNC Management, LLC and American Capital Agency Corp.                                                                                                       |
| 10.2 | Amendment and Joinder Agreement, dated as of September 30, 2011, by and between American Capital Agency TRS, LLC and American Capital AGNC Management, LLC.                                                                                                                                 |
| 31.1 | Certification of CEO Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                          |
| 31.2 | Certification of CFO Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                          |
| 32   | Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                     |

\* Fully or partly previously filed

## INDEX TO EXHIBITS

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\* Fully or partly previously filed

**SIGNATURES**

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

AMERICAN CAPITAL AGENCY CORP.

Date: November 7, 2011

By: /s/ MALON WILKUS  
Malon Wilkus  
Chair of the Board and  
Chief Executive Officer