Western Asset Mortgage Capital Corp
Form 10-Q
August 11, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

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

For the transition period from to

Commission File Number: 001-35543

Western Asset Mortgage Capital Corporation

(Exact name of Registrant as specified in its charter)

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

Western Asset Mortgage Capital Corporation

385 East Colorado Boulevard

Pasadena, California 91101

(Address of Registrant s principal executive offices)

(626) 844-9400

(Registrant s telephone number, including area code)

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

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

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

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

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

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

As of August 4, 2014, there were 41,718,467 shares, par value $0.01, of the registrant s common stock issued and outstanding.

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Western Asset Mortgage Capital Corporation

Balance Sheets (Unaudited)

(in thousands except share and per share data)

	June 30, 2014	December 31, 2013
Assets:		
Cash and cash equivalents	$ 1,047	$ 48,525
Mortgage-backed securities and other securities, at fair value ($4,621,548 and $2,818,947 pledged as collateral, at fair value, respectively)	4,674,131	2,853,587
Linked transactions, net, at fair value	13,075	18,559
Investment related receivable ($1,716 and $0 pledged as collateral, at fair value, respectively)	67,822	341
Accrued interest receivable	26,705	12,266
Due from counterparties	135,259	55,434
Derivative assets, at fair value	68,430	105,826
Other assets	813	339
Total Assets	$ 4,987,282	$ 3,094,877
Liabilities and Stockholders Equity:		
Liabilities:		
Borrowings under repurchase agreements	$ 4,111,248	$ 2,579,067
Accrued interest payable	22,639	12,534
Investment related payables	56,977	
Due to counterparties	19,436	65,861
Derivative liability, at fair value	105,570	4,673
Accounts payable and accrued expenses	1,637	1,353
Underwriting and offering costs payable	150	8
Payable to related party	2,758	1,842
Dividend payable	27,951	19,445
Total Liabilities	4,348,366	2,684,783
Commitments and contingencies		
Stockholders Equity:		
Common stock, $0.01 par value, 500,000,000 shares authorized, 41,718,467 and 26,853,287 shares issued and outstanding, respectively	417	268
Preferred stock, $0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	759,783	544,143
Retained earnings (accumulated deficit)	(121,284)	(134,317)
Total Stockholders Equity	638,916	410,094
Total Liabilities and Stockholders Equity	$ 4,987,282	$ 3,094,877

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Operations (Unaudited)

(in thousands except share and per share data)

	For the three months ended June 30, 2014	For the three months ended June 30, 2013, as Revised	For the six months ended June 30, 2014	For the six months ended June 30, 2013, as Revised
Net Interest Income:				
Interest income	$ 44,604	$ 32,742	$ 68,034	$ 66,492
Interest expense	5,971	4,522	9,361	9,703
Net Interest Income	38,633	28,220	58,673	56,789
Other Income (Loss):				
Interest income on cash balances and other income (loss), net	24	12	12	45
Realized gain (loss) on sale of Mortgage-backed securities and other securities, net	(11,278)	(6,083)	(7,562)	(17,743)
Other loss on Mortgage-backed securities and other securities	(2,999)	(3,533)	(4,708)	(5,801)
Unrealized gain (loss) on Mortgage-backed securities and other securities, net	114,117	(156,286)	145,208	(211,045)
Gain on linked transactions, net	688	3,909	2,907	4,505
Gain (loss) on derivative instruments, net	(66,677)	109,474	(126,583)	124,314
Other Income (Loss), net	33,875	(52,507)	9,274	(105,725)
Operating Expenses:				
General and administrative (includes $479, $251, $1,067 and $537 non-cash stock based compensation, respectively)	2,375	1,541	4,450	3,278
Management fee related party	2,559	1,826	4,364	3,939
Total Operating Expenses	4,934	3,367	8,814	7,217
Net income (loss) available to Common Stock and participating securities	$ 67,574	$ (27,654)	$ 59,133	$ (56,153)
Net income (loss) per Common Share Basic	$ 1.68	$ (1.16)	$ 1.76	$ (2.34)
Net income (loss) per Common Share Diluted	$ 1.68	$ (1.16)	$ 1.76	$ (2.34)
Dividends Declared per Share of Common Stock	$ 0.67	$ 1.85	$ 1.34	$ 1.85

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Changes in Stockholders Equity (Unaudited)

(in thousands except shares and share data)

	Common Stock Shares	Common Stock Par	Additional Paid-In Capital	Retained Earnings (Accumulated) Deficit	Total
Balance at December 31, 2013	26,853,287	$ 268	$ 544,143	$ (134,317)	$ 410,094
Proceeds from public offering of common stock, net	14,000,000	140	205,240		205,380
Offering costs, public offerings of common stock			(386)		(386)
Proceeds from private placement of common stock	650,000	7	9,646		9,653
Grants of restricted stock	215,180	2	(2)		
Vesting of restricted stock			1,129		1,129
Net income				59,133	59,133
Dividends on common stock			13	(46,100)	(46,087)
Balance at June 30, 2014	41,718,467	$ 417	$ 759,783	$ (121,284)	$ 638,916

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Cash Flows (Unaudited)

(in thousands)

	For the six months ended June 30, 2014	For the six months ended June 30, 2013
Cash flows from operating activities:		
Net income (loss)	$ 59,133	$ (56,153)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Premium amortization and (discount accretion), net	4,214	14,199
Restricted stock amortization expense	1,067	505
Unrealized (gain) loss on Mortgage-backed securities and other securities, net	(145,208)	211,045
Mark-to-market adjustments on linked transactions	(590)	(711)
Mark-to-market adjustments on derivative instruments	132,126	(90,303)
Other loss on Mortgage-backed securities and other securities	4,708	5,801
Realized loss on sale of Mortgage-backed securities and other securities, net	7,562	17,743
Realized loss on sale of Interest-Only Strips accounted for as derivatives, net	1,144	99
Realized (gain) loss on sale of TBAs, net	(22,561)	2,563
Realized (gain) loss on sale of swaptions, net	5,908	(1,038)
Realized loss on futures	16,495	
Realized loss on expiration of option derivatives, net		925
Realized gain on linked transaction, net	(1,290)	(3,748)
Realized gain on termination of swaps		(8,895)
Changes in operating assets and liabilities:		
(Increase) decrease in accrued interest receivable	(14,439)	2,253
Increase in other assets	(474)	(406)
Increase (decrease) in accrued interest payable	10,105	(674)
Increase in accounts payable and accrued expenses	346	323
Increase in payable to related party	916	92
Net cash provided by operating activities	59,162	93,620
Cash flows from investing activities:		
Purchase of Mortgage-backed securities and other securities	(3,490,944)	(1,725,304)
Purchase of securities underlying linked transactions	(25,141)	(76,408)
Proceeds from sale of Mortgage-backed securities and other securities	1,692,817	2,209,607
Proceeds from sale of securities underlying linked transactions		21,733
Principal payments and basis recovered on Mortgage-backed securities and other securities	137,908	156,970
Principal payments and basis recovered on securities underlying linked transactions	3,777	1,043
Payment of premium for option derivatives		(4,675)
Premium received from option derivatives		3,750
Proceeds from gross settlement of TBAs		208,312
Net settlements of TBAs	22,561	(2,058)
Proceeds from currency swaps	25,160	
Payment on termination of futures	(16,495)	
Proceeds from sale of interest rate swaptions		16,325
Premium for interest rate swaptions, net	(323)	(23,544)
Net cash provided by (used in) investing activities	(1,650,680)	785,751
Cash flows from financing activities:		

Proceeds from issuance of common stock		205,380		
Proceeds from private placement of common stock (concurrent with initial public offering)		9,653		
Payment of offering costs		(244)		(67)
Proceeds from repurchase agreement borrowings		11,783,312		20,074,104
Proceeds from repurchase agreement borrowings underlying linked transactions		75,809		86,245
Repayments of repurchase agreement borrowings		(10,241,325)		(20,907,205)
Repayments of repurchase agreement borrowings underlying linked transactions		(124,714)		(82,960)
Repayment of cash overdraft				(5,666)
Due from counterparties		(79,825)		(80,267)
Due to counterparties		(46,425)		39,000
Dividends on common stock		(37,581)		(50,131)
Net cash provided by (used in) financing activities		1,544,040		(926,947)
Net decrease in cash and cash equivalents		(47,478)		(47,576)
Cash and cash equivalents beginning of period		48,525		56,292
Cash and cash equivalents end of period	$	1,047	$	8,716
Supplemental disclosure of operating cash flow information:				
Interest paid	$	7,755	$	11,681
Interest rate swaps terminated, not settled	$		$	8,895
Supplemental disclosure of non-cash financing/investing activities:				
Principal payments of mortgage-backed securities, not settled	$	(237)	$	
Mortgage-backed securities and other securities sold, not settled	$	35,615	$	3,465
Mortgage-backed securities and other securities purchased, not settled	$	(5,106)	$	(22,167)
Mortgage-backed securities recorded upon unlinking of linked transactions	$	(62,435)	$	53,159
Mortgage-backed securities used to settle TBAs	$		$	208,817
Deferred offering costs payable	$	142	$	
Repurchase agreements, not settled	$	(9,806)	$	
Repurchase agreements underlying linked transactions, not settled	$	15,198	$	
Currency swaps, not settled	$	(25,160)	$	
Dividends and distributions declared, not paid	$	27,951	$	21,878

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Notes to Financial Statements (Unaudited)

(in thousands-except share and per share data)

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

Note 1 Organization

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

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

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

Note 2 Summary of Significant Accounting Policies

Basis of Presentation

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

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

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The Company currently operates as one business segment.

Cash and Cash Equivalents

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

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

Mortgage-backed and other securities - Fair value election

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

Balance Sheet Presentation

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

Valuation of financial instruments

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Interest income recognition and Impairment

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

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

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

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

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

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

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

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

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

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

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

Sales of securities

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

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

Foreign currency transactions

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

Due from counterparties/Due to counterparties

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

Derivatives and hedging activities

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

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

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

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

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

Repurchase agreements

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

Linked transactions

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

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Share-based compensation

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

Warrants

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

Income taxes

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

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

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

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

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Offering costs

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

Earnings per share

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

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

Comprehensive Income (Loss)

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

Accounting standards applicable to emerging growth companies

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

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

Recent accounting pronouncements

Accounting Standards to be Adopted in Future Periods

In April 2014, the Financial Accounting Standards Board issued updated guidance that changes the requirements for reporting discontinued operations. Under the new guidance, a discontinued operation is defined as a disposal of a component of an entity or group of components of an entity that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity s operations and financial results. The guidance is effective prospectively as of the first quarter of 2015, with early adoption permitted for new disposals or new classifications as held-for-sale. The guidance is effective for annual periods beginning on or after December 15, 2014 and interim periods within annual periods beginning on or after December 15, 2015. Early adoption is permitted but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue. The new guidance is not expected to have a material impact on the Company s financial statements.

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

Note 3 Fair Value of Financial Instruments

Fair Value Accounting Elections

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

Financial Instruments carried at Fair Value

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

	June 30, 2014 Fair Value			
	Level I	Level II	Level III	Total
Assets				
Agency RMBS	$	$ 3,375,807	$ 4,796	$ 3,380,603
Agency and Non-Agency Interest-Only Strips accounted for as derivatives, included in MBS		91,213	4,349	95,562
Non-Agency RMBS		683,089	69,737	752,826
Agency and Non-Agency CMBS		359,592	51,702	411,294
Other securities		33,846		33,846
Subtotal		4,543,547	130,584	4,674,131
Derivative assets	437	67,993		68,430
Non-Agency RMBS linked transactions		2,943		2,943
Non-Agency CMBS linked transactions, including Non U.S.		10,132		10,132
Total	$ 437	$ 4,624,615	$ 130,584	$ 4,755,636

Liabilities								
Derivative liabilities	$	548	$	104,159	$	863	$	105,570
Total	$	548	$	104,159	$	863	$	105,570

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

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

	Mortgage-backed securities and other securities							
$ in thousands	Three months ended June 30, 2014		Three months ended June 30, 2013		Six months ended June 30, 2014		Six months ended June 30, 2013	
Beginning balance	$	56,441	$		$	15,681	$	
Transfers into Level III from Level II		17,823				37,291		
Transfers out Level III into Level II		(16,703)				(16,703)		
Purchases		93,564				113,418		
Sales and settlements		(23,442)				(23,442)		
Principal repayments		(19)				(19)		
Total net gains/(losses) included in net income								
Realized gains/(losses), net		2,861				2,861		
Other loss on Mortgage-backed securities								
Unrealized gains/(losses), net(1)		857				2,371		
Premium and discount amortization, net		(798)				(874)		
Ending balance	$	130,584	$		$	130,584	$	

(1) For Mortgage-backed securities and other securities classified as Level III at June 30, 2014, the Company recorded gross unrealized gains of approximately $1.1 million and $1.3 million and gross unrealized losses of $377 thousand and $377 thousand for the three and six months ended June 30, 2014, respectively. These gains and losses are included in Unrealized gain (loss) on Mortgage-backed securities and other securities, net on the Statement of Operations.

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	Derivative assets			
$ in thousands	**Three months ended June 30, 2014**	**Three months ended June 30, 2013**	**Six months ended June 30, 2014**	**Six months ended June 30, 2013**
Beginning balance	$ 126	$	$	$
Transfers into Level III from Level II			126	
Transfers out Level III into Level II				
Purchases				
Sales and settlements				
Principal repayments				
Total net gains/(losses) included in net income				
Realized gains/(losses), net	(1,163)		(1,163)	
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net	1,037		1,037	
Premium and discount amortization, net				
Ending balance	$	$	$	$

	Derivative liabilities			
$ in thousands	**Three months ended June 30, 2014**	**Three months ended June 30, 2013**	**Six months ended June 30, 2014**	**Six months ended June 30, 2013**
Beginning balance	$	$	$	$
Transfers into Level III from Level II				
Transfers out Level III into Level II				
Purchases				
Sales and settlements				
Principal repayments				
Total net gains/(losses) included in net income				
Realized gains/(losses), net				
Other loss on Mortgage-backed securities				
Unrealized gains/(losses), net	863		863	
Premium and discount amortization, net				
Ending balance	$ 863	$	$ 863	$

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

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

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Other Fair Value Disclosures

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

The fair value of the repurchase agreements is based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best estimate current market interest rates that would be offered for loans with similar characteristics and credit quality. The use of different market assumptions or estimation methodologies could have a material effect on the fair value amounts. At June 30, 2014, the Company s borrowings under repurchase agreements had a fair value of approximately $4.1 billion and a carrying value of approximately $4.1 billion and would be considered a Level II fair value measurement.

Note 4 Mortgage-Backed Securities and other securities

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

	June 30, 2014						
	Principal Balance	**Unamortized Premium (Discount), net**	**Discount Designated as Credit Reserve and OTTI**	**Amortized Cost**	**Unrealized Gain (Loss), net**	**Estimated Fair Value**	**Net Weighted Average Coupon (1)**
Agency RMBS:							
20-Year Mortgage	$ 1,069,883	$ 60,249	$	$ 1,130,132	$ (2,677)	$ 1,127,455	3.6%
30-Year Mortgage	1,910,531	151,488		2,062,019	(23,092)	2,038,927	4.1%
Agency RMBS Interest-Only Strips	N/A	N/A	N/A	208,738	5,483	214,221	4.2%(2)
Agency and Non-Agency Interest-Only Strips, accounted for as derivatives (3)	N/A	N/A	N/A	N/A	N/A	95,562	2.9%(2)
Non-Agency RMBS	878,940	(10,420)	(179,891)	688,629	9,349	697,978	3.3%
Non-Agency RMBS Interest- Only Strips	N/A	N/A	N/A	52,584	2,264	54,848	6.1%
Agency and Non-Agency CMBS	430,439	1,733	(26,483)	405,689	5,605	411,294	5.4%
Other securities	25,560	4,580		30,140	3,706	33,846	7.3%
Total	$ 4,315,353	$ 207,630	$ (206,374)	$ 4,577,931	$ 638	$ 4,674,131	4.0%

	December 31, 2013						
	Principal Balance	**Unamortized Premium (Discount), net**	**Discount Designated as Credit Reserve and OTTI**	**Amortized Cost**	**Unrealized Gain (Loss), net**	**Estimated Fair Value**	**Net Weighted Average Coupon (1)**
Agency RMBS:							

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

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

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

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

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As of June 30, 2014 and December 31, 2013, the weighted average expected remaining term to the expected maturity of the investment portfolio, excluding linked transactions was 7.9 years and 8.5 years, respectively.

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

	June 30, 2014	December 31, 2013
Principal balance	$ 4,315,353	$ 2,663,848
Amortized cost of Interest-Only Strips	261,322	182,927
Carrying value of Agency and Non-Agency Interest-Only Strips accounted for as derivatives	95,562	109,235
Unamortized premium	243,330	183,324
Unamortized discount	(35,700)	(61,140)
Discount designated as Credit Reserve and OTTI	(206,374)	(79,898)
Gross unrealized gains	56,980	19,798
Gross unrealized losses	(56,342)	(164,507)
Fair value	$ 4,674,131	$ 2,853,587

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

	Three months ended June 30, 2014		
	Discount Designated as Credit Reserve and OTTI	**Accretable Discount (1)**	**Amortizable Premium**
Balance at beginning of period	$ (96,949)	$ (53,916)	$ 58,213
Accretion of discount		2,288	
Amortization of premium			(199)
Realized credit losses	1,075		
Purchases	(111,998)	(89,407)	53,258
Sales	4,692	24,461	
Net impairment losses recognized in earnings	(1,999)		
Unlinking of Linked Transactions			
Transfers/release of credit reserve	(1,195)	9,206	(8,011)
Balance of end of period	$ (206,374)	$ (107,368)	$ 103,261

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

	Six months ended June 30, 2014		
	Discount Designated as Credit Reserve and OTTI	**Accretable Discount (1)**	**Amortizable Premium**
Balance at beginning of period	$ (79,898)	$ (71,295)	$ 20,625
Accretion of discount		7,544	

Amortization of premium			(3,668)
Realized credit losses	1,770		
Purchases	(131,725)	(95,088)	59,941
Sales	19,411	46,432	
Net impairment losses recognized in earnings	(2,476)		
Unlinking of Linked Transactions	(13,889)	(297)	32,132
Transfers/release of credit reserve	433	5,336	(5,769)
Balance of end of period	$ (206,374)	$ (107,368)	$ 103,261

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

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	Three months ended June 30, 2013		
	Discount Designated as Credit Reserve and OTTI	**Accretable Discount (1)**	**Amortizable Premium**
Balance at beginning of period	$ (120,480)	$ (29,755)	$ 22,804
Accretion of discount		1,378	
Amortization of premium			333
Realized credit losses	123		
Purchases	(5,508)	(8,880)	
Sales	74,113	9,434	(20,649)
Net impairment losses recognized in earnings			
Unlinking of Linked Transactions	(20,489)	(4,695)	3,438
Transfers/release of credit reserve	4,170	(3,787)	(383)
Balance of end of period	$ (68,071)	$ (36,305)	$ 5,543

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

	Six months ended June 30, 2013		
	Discount Designated as Credit Reserve and OTTI	**Accretable Discount (1)**	**Amortizable Premium**
Balance at beginning of period	$ (12,659)	$ (5,523)	$ 12
Accretion of discount		2,149	
Amortization of premium			660
Realized credit losses	242		
Purchases	(112,923)	(34,303)	22,360
Sales	74,113	9,434	(20,649)
Net impairment losses recognized in earnings			
Unlinking of Linked Transactions	(20,489)	(4,695)	3,438
Transfers/release of credit reserve	3,645	(3,367)	(278)
Balance of end of period	$ (68,071)	$ (36,305)	$ 5,543

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

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

	June 30, 2014								
	Less than 12 Months			**12 Months or More**			**Total**		
	Fair Value	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**	**Number of Securities**	**Fair Value**	**Unrealized Losses**	**Number of Securities**
Agency RMBS:									
20-Year Mortgage	$ 19,301	$ (89)	4	$ 451,448	$ (12,043)	55	$ 470,749	$ (12,132)	59
30-Year Mortgage	7,815	(7)	1	1,003,871	(39,290)	137	1,011,686	(39,297)	138
	46,293	(2,551)	14				46,293	(2,551)	14

Agency Interest-Only Strips															
Non-Agency RMBS		293,489		(2,048)	30							293,489		(2,048)	30
Agency and Non-Agency CMBS		96,993		(314)	12							96,993		(314)	12
Total	$	463,891	$	(5,009)	61	$	1,455,319	$	(51,333)	192	$	1,919,210	$	(56,342)	253

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	December 31, 2013				
Less than 12 Months		12 Months or More		Total	
	Number		Number		
Unrealized	of	Unrealized	of	Unrealized	