

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

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**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, 2013**

OR

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**ARMOUR RESIDENTIAL REIT, INC.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of incorporation or organization)

**001-34766**

(Commission File Number)

**26-1908763**

(I.R.S. Employer Identification No.)

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

(Address of principal executive offices)(zip code)

**(772) 617-4340**

(Registrant's telephone number, including area code)

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

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

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

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

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

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

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**ARMOUR Residential REIT, Inc.**

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**ARMOUR Residential REIT, Inc. and Subsidiary****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share amounts)

(Unaudited)

**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

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

Commitments and contingencies (Note 9)

Stockholders' Equity:

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

See notes to condensed consolidated financial statements.

## ARMOUR Residential REIT, Inc. and Subsidiary

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(Unaudited)

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

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

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

See notes to condensed consolidated financial statements.

**ARMOUR Residential REIT, Inc. and Subsidiary**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(in thousands)

(Unaudited)

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

See notes to condensed consolidated financial statements.



**ARMOUR Residential REIT, Inc. and Subsidiary**

**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

(in thousands, except per share amounts)

(Unaudited)

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

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withholding requirements													
Common stock repurchased	-	-	-	-	-	-	(3,396 )	(4 )	(20,256 )	(20,256 )	-	-	-
Net income	-	-	-	-	-	-	-	-	-	-	353,732	-	-
Other comprehensive loss	-	-	-	-	-	-	-	-	-	-	-	-	(8,000 )
<b>Balance, September 30, 2013</b>	2,181	\$2	\$53,172	5,650	\$6	\$136,547	370,905	\$371	\$2,596,840	\$2,786,559	\$(42,635 )	\$(5,000 )	\$(8,000 )

See notes to condensed consolidated financial statements.

**ARMOUR Residential REIT, Inc. and Subsidiary****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(Unaudited)**

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

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

See notes to condensed consolidated financial statements

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1 – Basis of Presentation**

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

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

**Note 2 – Organization and Nature of Business Operations**

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

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

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

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

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

### **Note 3 – Summary of Significant Accounting Policies**

#### *Cash and cash equivalents*

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



**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*Cash Collateral Posted/Held*

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

**September 30, 2013**

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

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

**December 31, 2012**

	<b>Assets at  Fair Value (1) (in thousands)</b>	<b>Liabilities at  Fair Value (1)</b>
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Interest rate swap contracts	\$261,364	\$	-
Futures Contracts	4,188		-
<b>Totals</b>	<b>\$265,552</b>	<b>\$</b>	<b>-</b>

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

#### *Agency Securities, at Fair Value*

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

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

#### *Accrued Interest Receivable and Payable*

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

#### *Repurchase Agreements*

We finance the acquisition of our Agency Securities through the use of repurchase agreements. Our repurchase agreements are secured by our Agency Securities and bear interest rates that have historically moved in close relationship to the Federal Funds Rate and the London Interbank Offered Rate (“LIBOR”). Under these repurchase agreements, we sell Agency Securities to a lender and agree to repurchase the same Agency Securities in the future for a price that is higher than the original sales price. The difference between the sales price that we receive and the repurchase price that we pay represents interest paid to the lender. A repurchase agreement operates as a financing arrangement under which we pledge our Agency Securities as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. We retain beneficial ownership of the

pledged collateral. At the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral from the lender or, with the consent of the lender, we may renew such agreement at the then prevailing interest rate. The repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of the existing pledged collateral declines.

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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

*Obligations to Return Securities Received as Collateral, at Fair Value*

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

*Derivatives, at Fair Value*

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

*Credit Risk*

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

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

*Market Risk*

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

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*Preferred Stock*

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

*Series A Cumulative Preferred Shares (“Series A Preferred Stock”)*

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

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

a change of control by the holders of Series A Preferred Stock.

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

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*Common Stock*

*Common Stock and Warrants*

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

*Common Stock Repurchased*

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

*Revenue Recognition*

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

#### *Comprehensive Income (Loss)*

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

#### **Note 4 – Recent Accounting Pronouncements**

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

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



**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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

**Note 5 – Fair Value of Financial Instruments**

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

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

*Level 2 Inputs* - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

*Level 3 Inputs* - Instruments with primarily unobservable value drivers.

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

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

posted to or held by counterparties as collateral are classified as Level 2.

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

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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

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

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

**(Level  
1)  
(in thousands)**

## Assets at Fair Value:

Agency Securities, available for sale	\$-	\$19,096,562	\$	-	\$19,096,562
Derivatives	\$-	\$5,367	\$	-	\$5,367

## Liabilities at Fair Value:

Derivatives	\$3,919	\$186,621	\$	-	\$190,540
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The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed as of September 30, 2013 and December 31, 2012.

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

**ARMOUR Residential REIT, Inc. and Subsidiary****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

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

**Note 6 – Agency Securities, Available for Sale**

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

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

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

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

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

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

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

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

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

of principal and prepayments of principal.

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

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

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



**ARMOUR Residential REIT, Inc. and Subsidiary****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

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

**Unrealized Loss Position For:**

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

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

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

**Note 7 – Repurchase Agreements**

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

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

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

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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

**Note 8 – Derivatives**

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

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

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

Our Futures Contracts are traded on the CME which requires the use of daily mark-to-market collateral and the CME provides substantial credit support. The collateral requirements of the CME require us to pledge assets under a

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

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

**September 30, 2013**

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

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

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

## ARMOUR Residential REIT, Inc. and Subsidiary

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

December 31, 2012

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

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

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

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

September 30, 2013

Assets	Gross Amounts of Assets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet Financial Instruments	Cash Collateral	Net Amount
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	<b>Presented in the Condensed Consolidated Balance Sheet (in thousands)</b>	<b>Held (1)</b>		
Interest rate swap contracts	\$327,174	\$(107,932)	\$(204,651 )	\$ 14,591
Interest rate swaptions	63,511	-	-	63,511
<b>Totals</b>	<b>\$390,685</b>	<b>\$(107,932)</b>	<b>\$(204,651 )</b>	<b>\$ 78,102</b>

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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

**December 31, 2012**

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

**Gross Amounts  
Not Offset in the  
Condensed  
Consolidated**

**Balance Sheet**

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



**ARMOUR Residential REIT, Inc. and Subsidiary****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

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

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

**Note 9 – Commitments and Contingencies***Management Agreement with ARRM*

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

#### *Indemnifications and Litigation*

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 10 – Stock Based Compensation**

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

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

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

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

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

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

## Note 11 – Stockholders’ Equity

### *Dividends*

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

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

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

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

<b>Record Date</b>	<b>Payment Date</b>	<b>Rate per Series B Preferred Share</b>	<b>Aggregate amount paid to holders of record</b>
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		(in millions)	
March 15, 2013	March 27, 2013	\$ 0.25	\$ 1.4
April 15, 2013	April 29, 2013	\$ 0.16	\$ 0.9
May 15, 2013	May 27, 2013	\$ 0.16	\$ 0.9
June 14, 2013	June 27, 2013	\$ 0.16	\$ 0.9
July 15, 2013	July 29, 2013	\$ 0.16	\$ 0.9
August 15, 2013	August 27, 2013	\$ 0.16	\$ 0.9
September 15, 2013	September 27, 2013	\$ 0.16	\$ 0.9

### *Equity Capital Raising Activities*

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

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

(1) Weighted average price

**ARMOUR Residential REIT, Inc. and Subsidiary****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)***Common Stock repurchases*

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

**Note 12 – Net Income (Loss) per Common Share**

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

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

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

### Note 13 – Income Taxes

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

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

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

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



**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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

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

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

**Note 14 – Related Party Transactions**

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

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

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

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

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

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

**ARMOUR Residential REIT, Inc. and Subsidiary**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 15 – Interest Rate Risk**

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

**Note 16 – Subsequent Events**

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

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

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



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

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

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

### Overview

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

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

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

hedge interest rate risks. We believe that the residential mortgage market will undergo significant changes in the coming years as the role of GSEs, such as Fannie Mae and Freddie Mac, is diminished, which we expect will create attractive investment opportunities for us. We execute our business plan in a manner consistent with our intention of qualifying as a REIT under the Internal Revenue Code, (the “Code”) and avoid regulation as an investment company under the Investment Company Act of 1940 (the “1940 Act”).

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

### **Factors that Affect our Results of Operations and Financial Condition**

Our results of operations and financial condition are affected by various factors, many of which are beyond our control, including, among other things, our net interest income, the market value of our assets and the supply of and demand for such assets. We invest in financial assets and markets. Recent events, such as those discussed below, can affect our business in ways that are difficult to predict and may produce results outside of typical operating variances. Our net interest income varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. Prepayment rates, as reflected by the rate of principal pay downs and interest rates vary according to the type of investment, conditions in financial markets, government actions, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment rates on our Agency Securities purchased at a premium increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. Because changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to manage interest rate risks and prepayment risks effectively while maintaining our status as a REIT.

For any period during which changes in the interest rates earned on our assets do not coincide with interest rate changes on our borrowings, such assets will tend to reprice more slowly than the corresponding liabilities. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net interest income. With the maturities of our assets generally of longer term than those of our liabilities, interest rate increases will tend to decrease our net interest income and the market value of our assets (and therefore our book value). Such rate increases could possibly result in operating losses or adversely affect our ability to make distributions to our stockholders.

Prepayments on Agency Securities and the underlying mortgage loans may be influenced by changes in market interest rates and a variety of economic and geographic factors, policy decisions by regulators, as well as other factors beyond our control. Consequently prepayment rates cannot be predicted with certainty. To the extent we hold Agency Securities acquired at a premium or discount to par, or face value, changes in prepayment rates may impact our anticipated yield. In periods of declining interest rates, prepayments on our Agency Securities will likely increase. If we are unable to reinvest the proceeds of such prepayments at comparable yields, our net interest income may decline. The recent climate of government intervention in the mortgage markets significantly increases the risk associated with prepayments.

While we use strategies to economically hedge some of our interest rate risk, we do not hedge all of our exposure to changes in interest rates and prepayment rates, as there are practical limitations on our ability to insulate our securities portfolio from all potential negative consequences associated with changes in short-term interest rates in a manner that will allow us to seek attractive net spreads on our securities portfolio. Also, since we have not elected to use cash flow hedge accounting, earnings reported in accordance with generally accepted accounting principles in the U.S. (“GAAP”) will fluctuate even in situations where our derivatives are operating as intended. As a result of this mark-to-market accounting treatment, our results of operations are likely to fluctuate far more than if we were to designate our derivative activities as cash flow hedges. Comparisons with companies that use cash flow hedge accounting for all or part of their derivative activities may not be meaningful. For these and other reasons more fully described under the section captioned “Derivative Instruments” below, no assurance can be given that our derivatives will have the desired beneficial impact on our results of operations or financial condition.

In addition to the use of derivatives to hedge interest rate risk, a variety of other factors relating to our business may also impact our financial condition and operating performance; these factors include,

- our degree of leverage;
- our access to funding and borrowing capacity;
- the REIT requirements under the Code; and
- the requirements to qualify for an exemption under the 1940 Act and other regulatory and accounting policies related to our business.

## **Our Manager**

We are externally managed by ARRM, pursuant to the 2012 Management Agreement (see Note 14 to the condensed consolidated financial statements). All of our executive officers are also employees of ARRM. ARRM manages our day-to-day operations, subject to the direction and oversight of the Board of Directors (“Board”). The 2012 Management Agreement expires after an initial term of ten years on June 18, 2022 and is thereafter automatically renewed for an additional five-year term unless terminated under certain circumstances. Either party must provide 180 days prior written notice of any such termination. ARRM is entitled to receive a termination fee from us under certain circumstances.

Pursuant to the 2012 Management Agreement, ARRM is entitled to receive a management fee payable monthly in arrears in an amount equal to 1/12th of 1% of gross equity raised until gross equity raised was \$50 million. Currently, the monthly management fee is 1/12th of the sum of (a) 1.5% of gross equity raised up to \$1 billion plus (b) 0.75% of gross equity raised in excess of \$1 billion. The cost of repurchased stock reduces the amount of gross equity raised used to calculate the monthly management fee. As of September 30, 2013, the effective management fee was 1.016% based on gross equity raised. ARRM is entitled to receive a monthly management fee regardless of the performance of our securities portfolio. Accordingly, the payment of our monthly management fee may not decline in the event of a decline in our earnings and may cause us to incur losses. We incurred \$6.5 million and \$21.0 million, respectively in management fees for the quarter and nine months ended September 30, 2013. For the quarter and nine months ended September 30, 2012, we incurred \$5.6 million and \$13.4 million in management fees, respectively.

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

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



## **Market and Interest Rate Trends and the Effect on our Securities Portfolio**

The third quarter of 2013 represented a period of disruptive volatility in the prices of Agency Securities as well as underlying mortgages and U.S. Treasury Securities. The 10-Year Treasury Rate rose from 2.49% on June 28, 2013 to as high as 3.00% on September 5, 2013 before tightening to 2.61% on September 30, 2013. The widely followed benchmark 3.5% Fannie Mae certificates fell from a price of 101.48 on June 28, 2013 to a low of 97.95 on September 5, 2013 and recovered to a price of 101.92 on September 30, 2013. The cause of this volatility was widely attributed to concern about the market impact of a reduction in the Fed's overall bond buying program, and, particularly, a potential cut in its purchases of Agency Securities. On September 18th, the Fed announced its intention to continue purchasing both U.S. Treasury Securities and Agency Securities at their current level. Market prices for both U.S. Treasury Securities and Agency Securities both increased following that announcement.

The timing and impact of changes in the Fed's bond buying program are unknown. We expect continued volatility in the market for Agency Securities until the Fed clarifies its plans and actually begins implementation.

We made adjustments to our securities portfolio as a result of the market volatility in the third quarter in order to reduce exposure to changes in Agency Securities prices. During the third quarter we sold \$6.0 billion of Agency Securities resulting in a loss of \$301.0 million. As a result of these sales, leverage expressed as debt to stockholders' equity declined from 9.77:1 at June 30, 2013 to 6.93:1 at September 30, 2013. We did not reduce our hedge positions, which represented approximately 84.4% of our non-adjustable rate mortgages as of September 30, 2013. We still bear risk from changes in interest rates and, especially, from changes in the prices of Agency Securities relative to swap and Treasury prices.

We believe the current market environment offers attractive reinvestment opportunities. However, given the potential for further market volatility, we are likely to maintain a conservative posture on reinvestment, leverage, and hedging until we believe medium term risks have subsided.

### ***Developments at Fannie Mae and Freddie Mac***

Payments on the principal and interest on the Agency Securities in which we invest are guaranteed by Fannie Mae and Freddie Mac. Because of the guarantee and the underwriting standards associated with mortgages underlying Agency Securities, Agency Securities historically have had high stability in value and been considered to present low credit risk.

In February 2011, the U.S. Treasury along with the U.S. Department of Housing and Urban Development released a report entitled, "Reforming America's Housing Finance Market" to the U.S. Congress outlining recommendations for reforming the U.S. housing system, specifically Fannie Mae and Freddie Mac and transforming the U.S. Government's involvement in the housing market. It is unclear how future legislation may impact the housing finance market and the investing environment for Agency Securities as the method of reform is undecided and has not yet been defined by the regulators. Without U.S. Government support for residential mortgages, we may not be able to execute our current business model in an efficient manner.

In March 2011, the U.S. Treasury announced that it would begin the orderly wind down of Agency Securities it had purchased from Fannie Mae, Freddie Mac and Ginnie Mae to stabilize the housing market, with sales up to \$10.0 billion per month, subject to market conditions. We are unable to predict the timing or manner in which the U.S. Treasury or the U.S. Federal Reserve ("the Fed") will liquidate their holdings or make further interventions in the Agency Securities markets, or what impact, if any, such action could have on the Agency Securities market, the Agency Securities we hold, our business, results of operations and financial condition.

On June 25, 2013, a bipartisan group of U.S. senators introduced a draft bill titled, "Housing Finance Reform and Taxpayer Protection Act of 2013" to the U.S. Senate, which would wind down Fannie Mae and Freddie Mac over a period of five years and replace the public securitization market used by the GSEs with a public-private alternative market. On July 11, 2013, members of the U.S. House Committee on Financial Services introduced a similar draft bill titled, "Protecting American Taxpayers and Homeowners Act" to the U.S. House of Representatives. While distinguishable in some respects from the Senate version, the House bill would also eliminate Fannie Mae and Freddie Mac and seek to increase the opportunities for private capital to participate in, and consequently bear the risk of loss in connection with, government-guaranteed MBS.

The passage of any new legislation affecting Fannie Mae and Freddie Mac may create market uncertainty and reduce the actual or perceived credit quality of securities issued or guaranteed by the U.S. government through a new or existing successor entity to Fannie Mae and Freddie Mac. If Fannie Mae and Freddie Mac were reformed or wound down, it is unclear what effect, if any, this would have on the value of the existing Fannie Mae and Freddie Mac Agency Securities. It is also possible that the above-referenced proposed legislation, if made law, could adversely impact the market for securities issued or guaranteed by the U.S. government and the spreads at which they trade. The foregoing could materially adversely affect the pricing, supply, liquidity and value of the Agency Securities in which we invest and otherwise materially adversely affect our business, operations and financial condition.

We cannot predict whether or when new actions may occur, the timing and pace of current actions already implemented, or what impact if any, such actions, or future actions, could have on our business, results of operations and financial condition.

### ***U.S. Government Mortgage Related Securities Market Intervention***

In September 2012, the Fed announced a third quantitative easing program, popularly referred to as “QE3,” to purchase an additional \$40 billion of Agency Securities per month until the unemployment rate and other economic indicators improve. QE3 plus its existing investment programs grew the Fed’s Agency Securities holding by approximately \$85 billion per month at least through the end of 2012. On December 12, 2012, the Fed also announced that it would keep the target range for the Federal Funds Rate between zero and 0.25% for at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead was projected to be no more than 0.5% above the Fed’s 2% longer-run goal, and longer-term inflation expectations continued to be well anchored.

On May 22, 2013, Chairman Bernanke, responding to a question, stated “If we see continued improvement and we have confidence that that’s going to be sustained then we could in the next few meetings take a step down in our pace of purchases.” At the June 18-19, 2013 Federal Open Market Committee (“FOMC”) meeting, all but a few of the Committee members agreed to continue purchases of Agency Securities at their current pace.

On June 19, 2013, at the FOMC Press Conference, Chairman Bernanke, responding to a journalist's question referring to a hypothetically optimistic economy, stated “In that case, we would expect probably to slow or moderate purchases some time later this year, and then through the middle of through the early part of next year, and ending, in that scenario, somewhere in the middle of the year.”

In a press conference on July 12, 2013, Chairman Bernanke stated that a “highly accommodative monetary policy for the foreseeable future is what's needed in the U.S. economy.” At the July 30-31, 2013 FOMC meeting, most of the Committee members agreed, and voted to continue purchases of Agency Securities at the current pace. At the September 18, 2013 FOMC meeting the Committee decided to continue purchasing additional Agency Securities at a pace of \$40 billion per month and longer-term U.S. Treasury securities at a pace of \$45 billion per month and to keep in place the highly accommodative stance of monetary policy described at its December 11-12, 2012 meeting. Lower prices of Agency Securities reduces our book value and the amounts that we can borrow under repurchase agreements.

### ***Financial Regulatory Reform Bill and Other Government Activity***

We believe that we conduct our business in a manner that allows us to avoid being regulated as an investment company pursuant to the exclusion provided by Section 3(c)(5)(C) of the 1940 Act for entities that are primarily engaged in the business of purchasing or otherwise acquiring “mortgages and other liens on and interests in real estate.” On August 31, 2011, the SEC issued a concept release (No. IC-29778; File No. SW7-34-11, Companies Engaged in the Business of Acquiring Mortgages and Mortgage Related Instruments) pursuant to which it is reviewing whether certain companies that invest in MBS and rely on the exclusion from registration under Section 3(c)(5)(C) of the 1940 Act (such as us) should continue to be allowed to rely on such exclusion from registration. If we fail to continue to qualify for this exclusion from registration as an investment company, or the SEC determines that companies that invest in MBS are no longer able to rely on this exclusion, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as planned, or we may be required to register as an investment company under the 1940 Act, either of which could negatively affect the value of shares of our stock and our ability to make distributions to our stockholders.

Certain programs initiated by the U.S. Government, through the Federal Housing Finance Agency (“FHFA”) and the Federal Deposit Insurance Corporation (“FDIC”), to provide homeowners with assistance in avoiding residential mortgage loan foreclosures are currently in effect. The programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans or the rate of interest payable on the loans, or to extend the payment terms of the loans. While the effect of these programs has not been as extensive as originally expected, the effect of such programs for holders of Agency Securities could be that such holders would experience changes in the anticipated yields of their Agency Securities due to (i) increased prepayment rates and/or (ii) lower interest and principal payments.

In March 2009, the Home Affordable Modification Program (“HAMP”) was introduced to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. HAMP is designed to help at risk homeowners, both those who are in default and those who are at imminent risk of default, by providing the borrower with affordable and sustainable monthly payments.

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. The Dodd-Frank Act is extensive, complicated and comprehensive legislation that impacts practically all aspects of banking, and a significant overhaul of many aspects of the regulation of the financial services industry. Although many provisions remain subject to further rulemaking, the Dodd-Frank Act implements numerous and far-reaching changes that affect financial companies, including our company, and other banks and institutions which are important to our business model. Certain notable rules are, among other things:

Requiring regulation and oversight of large, systemically important financial institutions by establishing an interagency council on systemic risk and implementation of heightened prudential standards and regulation by the Board of Governors of the Fed for systemically important financial institutions (including nonbank financial companies), as well as the implementation of the FDIC resolution procedures for liquidation of large financial companies to avoid market disruption;

Applying the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies, savings and loan holding companies and systemically important nonbank financial companies;

Limiting the Fed's emergency authority to lend to nondepository institutions to facilities with broad-based eligibility, and authorizing the FDIC to establish an emergency financial stabilization fund for solvent depository institutions and their holding companies, subject to the approval of Congress, the Secretary of the U.S. Treasury and the Fed;

Creating regimes for regulation of over-the-counter derivatives and non-admitted property and casualty insurers and reinsurers;

Implementing regulation of hedge fund and private equity advisers by requiring such advisers to register with the SEC;

Providing for the implementation of corporate governance provisions for all public companies concerning proxy access and executive compensation; and

Reforming regulation of credit rating agencies.

Many of the provisions of the Dodd-Frank Act, including certain provisions described above are subject to further study, rulemaking, and the discretion of regulatory bodies. As the hundreds of regulations called for by the Dodd-Frank Act are promulgated, we will continue to evaluate the impact of any such regulations. It is unclear how this legislation may impact the borrowing environment, investing environment for Agency Securities and interest rate swap contracts as much of the bill's implementation has not yet been defined by the regulators.

In addition, in 2010, the Group of Governors and Heads of Supervisors of the Basel Committee on Banking Supervision, the oversight body of the Basel Committee, published its "calibrated" capital standards for major banking institutions ("Basel III"). Under these standards, when fully phased in on January 1, 2019, banking institutions will be required to maintain heightened Tier 1 common equity, Tier 1 capital and total capital ratios, as well as maintaining a "capital conservation buffer." Beginning with the Tier 1 common equity and Tier 1 capital ratio requirements, Basel III will be phased in incrementally between January 1, 2013 and January 1, 2019. The final package of Basel III reforms were approved by the Group of Twenty Finance Ministers and Central Bank Governors in November 2010 and are subject to individual adoption by member nations, including the U.S.

In October 2011, the FHFA announced changes to the Home Affordable Refinance Program (“HARP”) to expand access to refinancing for qualified individuals and families whose homes have lost value, including increasing the HARP loan to value ratio above 125%. However, this would only apply to mortgages guaranteed by the GSEs. There are many challenging issues to this proposal, notably the question as to whether a loan with a loan to value ratio of 125% qualifies as a mortgage or an unsecured consumer loan. The chances of this initiative’s success have created additional uncertainty in the Agency Securities market, particularly with respect to possible increases in prepayment rates.

On January 4, 2012, the Fed issued a white paper outlining additional ideas with regard to refinancings and loan modifications. It is likely that loan modifications would result in increased prepayments on some Agency Securities. These loan modification programs, as well as future legislative or regulatory actions, including amendments to the bankruptcy laws, that result in the modification of outstanding mortgage loans may adversely affect the value of, and the returns on, the Agency Securities in which we invest.

In an effort to continue to provide meaningful solutions to the housing crisis, effective June 1, 2012, the Obama administration expanded the population of homeowners that may be eligible for HAMP.

On September 28, 2012, the United Kingdom Financial Services Authority (“FSA”) released the results of its review of the process for setting the London Interbank Offered Rate (“LIBOR”) interest rate for various currencies and maturities (“Wheatley Review”). Some of our derivative positions use various maturities of U.S. dollar LIBOR. Our borrowings in the repurchase market have also historically tracked these LIBOR rates. The Wheatley Review found, among other things, that potential conflicts of interests coupled with insufficient oversight and accountability resulted in some reported LIBOR rates that did not reflect the true cost of inter-bank borrowings they were meant to represent.

The Wheatley Review also proposes a number of remedial actions, including:

- New statutory authority for the FSA to supervise and regulate the LIBOR setting process;
- Establishing a new independent oversight body to administer the LIBOR setting process;
- Eliminating LIBOR rates for certain currencies and maturities where markets are not sufficiently deep and liquid;
- Ceasing immediate reporting of rates submitted by individual participating banks; and
- Establishing controls to ensure that submitted rates represent actual transactions.

In April 2013, all the recommendations of the Wheatley Review came into force through the Financial Services Act of 2012. In this new regulatory framework, the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority ("PRA") have replaced the Financial Services Authority ("FSA"), the Bank of England has overall responsibility for financial stability, and a new Financial Policy Committee ("FPC") was created to assist the Bank in achieving its financial stability objective. Additionally, in September 2013, the European Commission proposed draft legislation that will enhance the robustness and reliability of benchmarks like LIBOR, facilitate the prevention and detection of their manipulation and clarify responsibility for and the supervision of benchmarks.

Our derivative and repurchase borrowings are conducted in U.S. dollars for maturities with historically deep and liquid markets. To date, implementation of the Wheatley Review recommendations have not had a material impact on the reported levels of LIBOR rates relevant to our derivative or repurchase borrowings.

On July 2, 2013, the Fed, in coordination with the FDIC and the Office of the Comptroller of the Currency (the "OCC"), approved a final rule that enhances bank regulatory capital requirements and implements certain elements of the Basel III capital reforms in the U.S. On July 9, 2013, the OCC approved the final rule and the FDIC approved the final rule as an interim rule. The final rule includes a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5 percent and a common equity tier 1 capital conservation buffer of 2.5 percent of risk-weighted assets that will apply to all supervised U.S. financial institutions. The final rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4 percent to 6 percent and includes a minimum leverage ratio of 4 percent for all U.S. banking organizations. The final rule will continue to apply existing risk-based capital standards with respect to residential loans, including a 50 percent risk weight for safely underwritten first-lien mortgages that are not past due. "Advanced approaches banking organizations," those with \$250 billion or more in total consolidated assets or \$10 billion or more in foreign exposures, will be required to comply with the final rule starting on January 1, 2014. Other banking organizations will be required to comply with the final rule starting January 1, 2015.

On July 9, 2013, the Fed, the FDIC, and the OCC proposed a rule to change the leverage ratio standards for the largest U.S. banking organizations. Under the proposed rule, bank-holding companies with more than \$700 billion in consolidated total assets or \$10 trillion in assets under custody would be required to maintain a tier 1 capital leverage buffer of at least 5 percent, which is 2 percent above the minimum supplementary leverage ratio requirement of 3 percent adopted by these three agencies in their Basel III capital reform rules on July 2, 2013. In addition to the leverage buffer, the proposed rule would require insured depository institutions of such large bank-holding companies

to meet a 6 percent supplementary leverage ratio to be considered "well capitalized." The proposed rule would apply starting January 1, 2018. Adoption of these rules may increase cost and reduce availability of repurchase funding provided by institutions subject to the rules.

### ***Credit Market Disruption and Current Conditions***

During the past few years, the residential housing and mortgage markets in the U.S. have experienced a variety of difficulties and changed economic conditions including loan defaults, credit losses and decreased liquidity. These conditions have resulted in volatility in the value of the Agency Securities we purchase and an increase in the average collateral requirements under our repurchase agreements we have obtained. While these markets have recovered significantly, further increased volatility and deterioration in the broader residential mortgage and residential mortgage backed securities ("RMBS") markets may adversely affect the performance and market value of the Agency Securities and other high quality RMBS.

### ***Short-term Interest Rates and Funding Costs***

In December 2008, the Fed stated that it was adopting a policy of "quantitative easing" and would target keeping the Federal Funds Rate between 0.00% and 0.25%. To date, the Fed has maintained that target range. Our funding costs, which traditionally have tracked the 30-day LIBOR have generally benefited by this easing of monetary policy, although to a somewhat lesser extent. Because of continued uncertainty in the credit markets and U.S. economic conditions, we expect that interest rates are likely to experience continued volatility, which will likely affect our financial results since our cost of funds is largely dependent on short-term rates.



Historically, 30-day LIBOR has closely tracked movements in the Federal Funds Rate and the Effective Federal Funds Rate. The Effective Federal Funds Rate can differ from the Federal Funds Rate in that the Effective index represents the volume weighted average of interest rates at which depository institutions lend balances at the Fed to other depository institutions overnight (actual transactions, rather than target rate).

Our borrowings in the repurchase market have also historically closely tracked the Federal Funds Rate and LIBOR. Traditionally, a lower Federal Funds Rate has indicated a time of increased net interest margin and higher asset values. However, for the past several years, LIBOR and repurchase market rates have varied greatly and often have been significantly higher than the target and the Effective Federal Funds Rate. The difference between 30-day LIBOR and the Effective Federal Funds Rate has also been quite volatile, with the spread alternately returning to more normal levels and then widening out again. The continued volatility in these rates and divergence from the historical relationship among these rates could negatively impact our ability to manage our securities portfolio. If this were to occur, our net interest margin and the value of our securities portfolio might suffer as a result.

The following table shows 30-day LIBOR as compared to the Effective Federal Funds Rate at September 30, 2013 and September 30, 2012.

	<b>30-Day</b>		<b>Effective</b>	
	<b>LIBOR</b>		<b>Federal</b>	
			<b>Funds</b>	
			<b>Rate</b>	
September 30, 2013	0.18	%	0.06	%
September 30, 2012	0.21	%	0.09	%

## **Results of Operations**

As a result of our continued equity raising efforts, our earnings as reported in our condensed consolidated financial statements, particularly on a per share basis, may take time to reach a level in which we consider to be indicative of a full run-rate. Some period over period comparisons in the discussion below may not be meaningful.

### ***Net Income Summary***

Our primary source of income is the interest income we earn on our securities portfolio. Our net income (loss) for the quarter and nine months ended September 30, 2013 (related) available to common stockholders was (\$233.8) million

and \$343.4 million, or (\$0.63) and \$1.28 per basic weighted average common share and (\$0.63) and \$1.27 per diluted weighted average common share, respectively. These results compare to net income of \$54.1 million and \$105.6 million available to common stockholders or \$0.20 and \$0.54 per basic and diluted weighted average common share, respectively, for the quarter and nine months ended September 30, 2012. The main factors for the difference between the quarter and nine months ended 2012 to the corresponding periods in 2013, were the increased equity capital resources and the continued implementation of our investment strategy, in addition to changes in value from our derivatives and increased management fees.

As of September 30, 2013 and December 31, 2012, our Agency Securities in our securities portfolio were carried at a net premium to par value with a weighted average amortized cost of 105.06% and 105.24%, respectively, due to the average interest rates on these securities being higher than prevailing market rates.

The following table presents the components of the yield earned on our Agency Security portfolio for the periods presented.

	<b>For the Quarters</b>		<b>For the Nine Months</b>			
	<b>Ended</b>		<b>Ended</b>			
	<b>September</b>		<b>September</b>			
	<b>30, 2013</b>	<b>30, 2012</b>	<b>30, 2013</b>	<b>30, 2012</b>		
Asset Yield	2.60%	2.70	%	2.47%	2.86	%
Cost of Funds	1.36%	0.89	%	1.15%	0.99	%
Net Interest Margin	1.24%	1.82	%	1.33%	1.87	%
Interest Expense on Repurchase Agreements	0.41%	0.45	%	0.44%	0.47	%

The yield on our assets is most significantly affected by the rate of repayments on our Agency Securities. Our rate of portfolio repayment for the quarter ended September 30, 2013, was 8.8% on a constant prepayment basis compared to 13.0% for the ended September 30, 2012.

Our repurchase agreements are secured by our Agency Securities and bear interest at rates that have historically moved in close relationship to the Federal Funds Rate and LIBOR. The Federal Funds Rate was 0.06% and LIBOR was 0.18% at September 30, 2013. During the quarter and nine months ended September 30, 2013, we realized losses of \$37.3 million, and \$105.2 million, respectively, related to our derivatives. During the quarter and nine months ended September 30, 2012, we realized losses of \$18.9 million, and \$41.1 million, respectively, related to our derivatives. We increased our total interest rate swap contracts aggregate notional balance from \$8.7 billion at December 31, 2012 to \$11.8 billion at September 30, 2013. At September 30, 2013 and December 31, 2012, our interest rate swap contracts had a weighted average swap rate of 1.4% and 1.2%, respectively and a weighted average term of 71 months and 64 months, respectively. We increased our total interest rate swaptions aggregate notional balance from \$1.1 billion at December 31, 2012 to \$2.3 billion at September 30, 2013. Our swaptions had an underlying weighted average swap rate of 2.6% and 2.1%, respectively and a weighted average term of 10 months and 5 months, respectively, at September 30, 2013 and December 31, 2012. The increased notional balance of our interest rate swap contracts and our swaptions is due to the growth in our securities portfolio and our repurchase agreement obligations, through June 30, 2013 and in response to the increased volatility in the market. Our total Eurodollar Futures Contracts (“Futures Contracts”) notional amount decreased from \$102.0 million at December 31, 2012 to \$74.0 million at September 30, 2013 due to the maturity of contracts. Our Futures Contracts had a weighted average swap equivalent rate of 2.1% and 1.8%, respectively and weighted average term of 16 months and 20 months, respectively, as of September 30, 2013 and December 31, 2012.

### ***Net Interest Income***

Our net interest income for the quarter and nine months ended September 30, 2013 was \$94.5 million and \$317.2 million, respectively, compared to \$97.5 million and \$228.4 million, respectively, for the quarter and nine months ended September 30, 2012. The continued growth of our net interest income from year to year is due to the completion of equity raises. The proceeds from these equity raises were invested in Agency Securities, creating a larger investment portfolio able to generate increasing levels of interest income. As of September 30, 2013 and December 31, 2012, our securities portfolio consisted of \$16.7 billion and \$19.1 billion of Agency Securities, respectively. In order to limit exposure to increasing volatility in the markets for U.S. Treasury and Agency Securities in the third quarter of 2013, we reduced our portfolio.

### ***Gains and Losses on Sale of Agency Securities***

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

*Gains and Losses on U.S. Treasury Securities*

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

*Expenses*

Our total expenses for the quarter and nine months ended September 30, 2013 were \$9.7 million and \$27.6 million, respectively, as compared to \$7.2 million and \$17.7 million, respectively, for the quarter and nine months ended September 30, 2012. The increase in expenses from year to year is primarily due to two factors. The first factor is due to increased management fees. Our total management fee expense for the quarter and nine months ended September 30, 2013, was \$6.5 million and \$21.0 million as compared to \$5.6 million and \$13.4 million for the quarter and nine months ended September 30, 2012. The \$6.5 million of management fee expense for the quarter ended September 30, 2013, reflects an adjustment to reclassify \$0.7 million of expense as compensation related to Restricted Stock awarded to ARRM for its employees previously classified as management fees. Management fees are determined based on gross equity raised. Therefore, our management fee increases when we raise capital and declines when we repurchase previously issued stock. However, because the management fee rate decreased to 0.75% per annum for gross equity raised in excess of \$1 billion pursuant to the 2012 Management Agreement, the effective average management fee rate has generally declined over time. The second factor is an increase in professional fees and operating costs to support our current securities portfolio.

***Taxable Income***

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

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

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

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

We are required and intend to timely distribute substantially all of our REIT taxable income in order to maintain our REIT status under the Code. Total dividend payments to stockholders were \$82.2 million and \$247.1 for the quarter and nine months ended September 30, 2013, respectively. Our estimated REIT taxable income available to pay dividends was \$3.8 million and \$181.2 million for the quarter and nine months ended September 30, 2013, respectively. We also carried forward from the year ended December 31, 2012, undistributed REIT taxable income of \$10.4 million. Our REIT taxable income and dividend requirements are determined on an annual basis. Dividends in

excess of REIT taxable income for the year (including taxable income carried forward from the previous year) will generally not be taxable to common stockholders.

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

## Financial Condition

### Agency Securities

We typically purchase Agency Securities at premium prices. The premium price paid over par value on those assets is expensed as the underlying mortgages experience repayment or prepayment. The lower the constant prepayment rate, the lower the amount of amortization expense for a particular period. Accordingly, the yield on an asset and earnings, are higher. If prepayment rates increase, the amount of amortization expense for a particular period will go up. These increased prepayment rates would act to decrease the yield on an asset and would decrease earnings.

The tables below summarize certain characteristics of our Agency Securities as of September 30, 2013 and December 31, 2012 (dollars in thousands).

### Agency Securities:

As of	Principal Amount	Net Unamortized Premium	Amortized Cost	Amortized		Fair Value	
				Cost divided by Principal	Fair Value	divided by Principal	
September 30, 2013	\$16,424,187	\$ 831,584	\$17,255,771	105.06	% \$16,664,917	101.47	%
December 31, 2012	\$17,925,998	\$ 940,000	\$18,865,998	105.24	% \$19,096,562	106.53	%



**Adjustable and Hybrid Adjustable Rate Agency Securities:**

<b>As of</b>	<b>Principal Amount</b>	<b>Weighted Average Coupon</b>	<b>Weighted Average Months to Reset</b>	<b>Weighted Average Percentage of Total Agency Securities</b>		
September 30, 2013	\$257,609	4.03	% 23	1.6	%	
December 31, 2012	\$2,037,778	3.69	% 66	11.4	%	

**Fixed Rate Agency Securities:**

<b>As of</b>	<b>Principal Amount</b>	<b>Weighted Average Coupon</b>	<b>Weighted Average Months to Maturity</b>	<b>Weighted Average Percentage of Total Agency Securities</b>		
September 30, 2013	\$16,166,578	3.38	% 299	98.4	%	
December 31, 2012	\$15,888,220	3.52	% 276	88.6	%	

The average principal repayment rate for settled Agency Securities for the quarter ended September 30, 2013 was 8.8% compared to 13.0% for the quarter ended September 30, 2012.

As of September 30, 2013, our Agency Security portfolio consisted of approximately \$16.7 billion in market value of Agency Securities with initial fixed-interest rate periods of ten, fifteen, twenty, twenty-five and thirty years. As of September 30, 2013, we had investment related payables of \$142.6 million with respect to unsettled purchases of Agency Securities and \$1.3 million related to unsettled interest rate swap contract purchases. All investment related payables at September 30, 2013 were settled in October 2013. As of December 31, 2012, we had investment related receivables of \$668.2 million with respect to unsettled sales of Agency Securities. We did not have any investment related payables as of December 31, 2012.

Our net income is primarily a function of the difference between the yield on our assets and the financing cost of owning those assets. Since we tend to purchase Agency Securities at a premium to par, the main item that can affect the yield on our Agency Securities after they are purchased is the rate at which the mortgage borrowers repay the loan.



While the scheduled repayments, which are the principal portion of the homeowners' regular monthly payments, are fairly predictable, the unscheduled repayments, which are generally refinancing of the mortgage but can also result from repurchases of delinquent, defaulted, or modified loans, are less so. Being able to accurately estimate and manage these repayment rates is a critical portion of the management of our securities portfolio, not only for estimating current yield but also for considering the rate of reinvestment of those proceeds into new securities, the yields which those new securities may add to our securities portfolio and our hedging strategy.

As of September 30, 2013 and December 31, 2012, the adjustable and hybrid adjustable rate mortgage loans underlying our Agency Securities have fixed-interest rates for an average period of approximately 23 months and 66 months, respectively, after which time the interest rates reset and become adjustable. After a reset date, interest rates on our adjustable and hybrid adjustable Agency Securities float based on spreads over various indices, typically LIBOR or the one-year Constant Maturity Treasury rate. These interest rates are subject to caps that limit the amount the applicable interest rate can increase during any year, known as an annual cap and through the maturity of the security, known as a lifetime cap.

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

### *Repurchase Agreements*

We have entered into repurchase agreements to finance most of our Agency Securities. Our repurchase agreements are secured by our Agency Securities and bear interest at rates that have historically moved in close relationship to the Federal Funds Rate and LIBOR. We have established borrowing relationships with several investment banking firms and other lenders, 26 of which we had done repurchase trades with as of September 30, 2013 and 26 of which we had done repurchases trades with as of December 31, 2012. We had outstanding balances under our repurchase agreements as of September 30, 2013 of \$14.9 billion. Our outstanding repurchase agreements balance at December 31, 2012 was \$18.4 billion.

### *Derivative Instruments*

We generally hedge our interest rate risk as ARRM deems prudent in light of market conditions and the associated costs with counterparties that have a high quality credit rating and with futures exchanges. We generally pay a fixed rate and receive a floating rate with the objective of fixing a portion of our borrowing costs and hedging the change in our book value to some degree. The floating rate we receive is generally the Federal Funds Rate or LIBOR. While our policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge, we maintain an overall target of hedging at least 40% of our non-adjustable rate mortgages. In order to limit exposure to increasing volatility in the markets for U.S. Treasury and Agency Securities in the third quarter of 2013, we reduced our portfolio. We did not reduce our hedge positions, which represented approximately 84.4% of our non-adjustable rate mortgages as of September 30, 2013. For interest rate risk mitigation purposes, we consider Agency Securities to be adjustable rate mortgages (“ARMs”) if their interest rate is either currently subject to adjustment according to prevailing rates or if they are within 18 months of the period where such adjustments will occur. No assurance can be given that our derivatives will have the desired beneficial impact on our results of operations or financial condition. We have not elected cash flow hedge accounting treatment as allowed by GAAP. Since we do not designate our derivative activities as cash flow hedges, realized as well as unrealized gains/losses from these transactions will impact our earnings.

Use of derivative instruments may fail to protect or could adversely affect us because, among other things:

- available derivatives may not correspond directly with the interest rate risk for which protection is sought (e.g., the difference in interest rate movements for long term U.S. Treasury Securities compared to Agency Securities);
- the duration of the derivatives may not match the duration of the related liability;
- the counterparty to a derivative agreement with us may default on its obligation to pay or not perform under the terms of the agreement and the collateral posted may not be sufficient to protect against any consequent loss;

we may lose collateral we have pledged to secure our obligations under a derivative agreement if the associated counterparty becomes insolvent or files for bankruptcy;  
we may experience a termination event under one or more of our derivative agreements related to our REIT status, equity levels and performance, which could result in a payout to the associated counterparty and a taxable loss to us;  
the credit-quality of the party owing money on the derivatives may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and  
the value of derivatives may be adjusted from time to time in accordance with GAAP to reflect changes in fair value; downward adjustments, or “mark-to-market losses,” would reduce our net income or increase any net loss.

As of September 30, 2013 and December 31, 2012, we had interest rate swap contracts with an aggregate notional balance of \$11.8 billion and \$8.7 billion, respectively. As of September 30, 2013 and December 31, 2012, we had entered into interest rate swaptions with an aggregate notional balance of \$2.3 million and \$1.1 billion, respectively. In addition, as of September 30, 2013 and December 31, 2012, we had purchased or sold Futures Contracts with an aggregate notional balance of \$74.0 million and \$102.0 million, respectively. Futures Contracts are traded on the Chicago Mercantile Exchange (“CME”). Counterparty risk of interest rate swap contracts, interest rate swaptions and Futures Contracts are limited to some degree because of daily mark-to-market and collateral requirements. In addition, substantial credit support for the Futures Contracts is provided by the CME. These derivative transactions are designed to lock in some funding costs for financing activities associated with our assets in such a way as to help assure the realization of attractive net interest margins and to vary inversely in value with our Agency Securities. Such contracts are based on assumptions about prepayments which, if not realized, will cause results to differ from expectations.

Although we attempt to structure our derivatives to offset the changes in asset prices, they are not perfectly correlated and depend on the corresponding durations and sections of the yield curve that moves to offset each other. We recognized net (losses) gains of (\$49.1) million and \$311.5 million for the quarter and nine months ended September 30, 2013, respectively, and (losses) of (\$50.4) million and (\$125.3) million for the quarter and nine months ended September 30, 2012, respectively, related to our derivatives. For the quarters and nine months ended September 30, 2013, the unrealized change in the fair value of our Agency Securities decreased by (\$51.8) million and (\$1.1) billion, respectively, compared to an increase of \$250.1 million and an increase of \$374.0 million for the quarter and nine months ended September 30, 2012, respectively.

As required by the Dodd-Frank Act, the Commodity Futures Trading Commission has adopted rules requiring certain interest rate swap contracts to be cleared through a derivatives clearing organization. We are required to clear certain new interest rate swap contracts as of June 2013. Cleared interest rate swaps may have higher margin requirements than un-cleared interest rate swaps previously had. We have established accounts with futures commission merchants for this purpose. To date, we have not entered into any cleared interest rate swap contracts.

## **Liquidity and Capital Resources**

During the nine months ended September 30, 2013, we issued 65,055,537 shares of common stock and raised additional net proceeds of approximately \$438.5 million. During the nine months ended September 30, 2013, we issued 174,961 shares of 8.250% Series A Cumulative Preferred Stock (“Series A Preferred Stock”) and issued 5,650,000 shares of 7.875% Series B Cumulative Preferred Stock (“Series B Preferred Stock”) for a combined net proceeds of approximately \$140.9 million. As a result, we were able to acquire additional assets, arrange additional repurchase agreement funding and increase economies of scale. During the nine months ended September 30, 2013, we repurchased 3,395,603 shares of our outstanding common stock under our stock repurchase program (the “Repurchase Program”) for an aggregate of \$20.3 million. At times, we purchased assets for forward settlement up to 90 days in the future to minimize purchase prices. Our management fee expense also increased in absolute terms under the provisions of our management agreement. However, pursuant to the 2012 Management Agreement, the average effective management fee rate declined because the management fee rate stepped down as the amounts of equity raised exceeded \$1.0 billion.

As of September 30, 2013, we financed our portfolio with approximately \$14.9 billion of borrowings under repurchase agreements. Our leverage ratio as of September 30, 2013, was 6.93 to 1. As of September 30, 2013, our liquidity totaled \$1.3 billion, consisting of \$0.5 billion of cash and cash equivalents plus \$0.8 billion of unpledged Agency Securities (including Securities received as collateral). Our primary sources of funds are borrowings under repurchase arrangements, monthly principal and interest payments on our Agency Securities and cash generated from our operating results. Other sources of funds may include proceeds from equity and debt offerings and asset sales. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of our borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on our balance sheet is significantly less important than our potential liquidity available under our borrowing arrangements.

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities back in the future. We then sell such U.S. Treasury Securities to third parties and recognize a liability to return the securities to the original borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement, settlement through the same brokerage or clearing account and maturing on the same day. The practical effect of these transactions is to replace a portion of our repurchase

agreement financing of our Agency Securities in our securities portfolio with short positions in U.S. Treasury Securities. We believe that this helps to reduce interest rate risk, and therefore counterparty credit and liquidity risk.

Both parties to the repurchase and reverse repurchase transactions have the right to make daily margin calls based on changes in the value of the collateral obtained and/or pledged.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on repurchase borrowings, reacquisition of securities to be returned to borrowers and the payment of cash dividends as required for continued qualification as a REIT.

Our primary uses of cash are to purchase Agency Securities, pay interest and principal on our borrowings, fund our operations and pay dividends. During the nine months ended September 30, 2013, we purchased \$12.4 billion of Agency Securities using proceeds from equity raises, repurchase agreements and principal repayments. During the nine months ended September 30, 2013, we received cash of \$2.8 billion from prepayments and scheduled principal payments on our Agency Securities. We received net proceeds of \$438.5 million from common equity issuances, including our common stock dividend reinvestment and stock purchase plan ("common stock DRIP") and \$4.4 million of proceeds from the issuance of 174,961 shares of Series A Preferred Stock and \$136.6 million of proceeds from the issuance of 5,650,000 shares of Series B Preferred Stock during the nine months ended September 30, 2013. We had a net cash decrease from our repurchase agreements of \$3.4 billion for the nine months ended September 30, 2013 and made cash interest payments of approximately \$198.1 million on our liabilities for the nine months ended September 30, 2013. Part of funding our operations includes providing margin cash to offset liability balances on our derivatives. We recovered \$234.6 million of cash collateral posted with counterparties and increased our liability by \$294.1 million for cash collateral held as of September 30, 2013.

In response to the growth of our Agency Securities in our securities portfolio and to the relatively weak financing market, we have continued to pursue additional lending counterparties in order to help increase our financial flexibility and ability to withstand periods of contracting liquidity in the credit markets.

**Repurchase Agreements**

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

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

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

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

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

Declines in the value of our Agency Securities in our securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event under the standard MRA would give our counterparty the option to terminate all repurchase transactions existing with us and require any amount due to be payable immediately.

The residential mortgage market in the U.S. experienced difficult economic conditions over the last several years including:

increased volatility of many financial assets, including Agency Securities and other high-quality RMBS assets; increased volatility and deterioration in the broader residential mortgage and RMBS markets; and significant disruption in financing of RMBS.

While conditions have improved, should there be a reoccurrence of difficulties in the residential mortgage market, our lenders may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of required equity capital or haircut, any of which could make it more difficult or costly for us to obtain financing.

Financial sector volatility can also lead to increased demand and prices for high quality debt securities, including Agency Securities. While increased prices may increase the value of our Agency Securities, higher values may also reduce the return on reinvestment of capital, thereby lowering our future profitability.

The following graph represents the month-end outstanding balances of our repurchase agreements (before the effect of netting reverse repurchase agreements), which finance most of our Agency Securities. Over time, the level of our repurchase agreement financing has grown in conjunction with the growth of Agency Securities in our securities portfolio, which in turn has been the result of successful equity capital raising efforts. The balance of repurchase agreements outstanding will fluctuate within any given month based on changes in the market value of the particular Agency Security pledged as collateral (including the effects of principal paydowns) and the level and timing of investment and reinvestment activity.

### *Effects of Margin Requirements, Leverage and Credit Spreads*

Our Agency Securities have values that fluctuate according to market conditions and, as discussed above, the market value of our Agency Securities will decrease as prevailing interest rates or credit spreads increase. When the value of the securities pledged to secure a repurchase agreement decreases to the point where the positive difference between



the collateral value and the loan amount is less than the haircut, our lenders may issue a margin call, which means that the lender will require us to pay the margin call in cash or pledge additional collateral to meet that margin call. Under our repurchase facilities, our lenders have full discretion to determine the value of the Agency Securities we pledge to them. Most of our lenders will value securities based on recent trades in the market. Lenders also issue margin calls as the published current principal balance factors change on the pool of mortgages underlying the securities pledged as collateral when scheduled and unscheduled principal repayments are announced monthly.

We experience margin calls in the ordinary course of our business and under certain conditions, such as during a period of declining market value for Agency Securities and we may experience margin calls as frequently as daily. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our liquidity. The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline and we may experience margin calls. We will use our liquidity to meet such margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. If we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness. In addition, certain of our MRAs contain a restriction that prohibits our leverage from exceeding twelve times our stockholders' equity as well as termination events in the case of significant reductions in equity capital.

We intend to maintain a level of liquidity in relation to our assets that enables us to meet reasonably anticipated margin calls but that also allows us to be substantially invested in Agency Securities. We may misjudge the appropriate amount of our liquidity by maintaining excessive liquidity, which would lower our investment returns, or by maintaining insufficient liquidity, which would force us to involuntarily liquidate assets into unfavorable market conditions and harm our results of operations and financial condition.

We generally seek to borrow (on a recourse basis) between six and ten times the amount of our total stockholders' equity. At September 30, 2013 and December 31, 2012, our total net borrowings were approximately \$14.9 billion and \$18.4 billion (excluding accrued interest), respectively. As of September 30, 2013 and December 31, 2012 we had a leverage ratio of approximately 6.93:1 and 7.96:1, respectively.

***Forward-Looking Statements Regarding Liquidity***

Based on our current portfolio, leverage rate and available borrowing arrangements, we believe that our cash flow from operations and our ability to make timely portfolio adjustments, will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements such as to fund our investment activities, meet our financing obligations, pay fees under the 2012 Management Agreement and fund our distributions to stockholders and pay general corporate expenses.

We may increase our capital resources by obtaining long-term credit facilities or making public or private offerings of equity or debt securities, including classes of preferred stock, common stock and senior or subordinated notes to meet our long-term (greater than one year) liquidity. Such financing will depend on market conditions for capital raises and for the investment of any proceeds and there can be no assurances that we will successfully obtain any such financing.

**Stockholders' Equity***Dividends*

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

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

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August 15, 2013	August 29, 2013	\$ 0.07	\$ 26.1
September 16, 2013	September 27, 2013	\$ 0.07	\$ 26.1

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

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

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

Record Date	Payment Date	Rate per Series B Preferred Share	Aggregate
			amount paid to holders of record (in millions)
March 15, 2013	March 27, 2013	\$ 0.25	\$ 1.4
April 15, 2013	April 29, 2013	\$ 0.16	\$ 0.9
May 15, 2013	May 27, 2013	\$ 0.16	\$ 0.9
June 14, 2013	June 27, 2013	\$ 0.16	\$ 0.9
July 15, 2013	July 29, 2013	\$ 0.16	\$ 0.9
August 15, 2013	August 27, 2013	\$ 0.16	\$ 0.9

September 15, 2013 September 27, 2013 \$ 0.16 \$ 0.9

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*Equity Capital Raising Activities*

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

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

(1) Weighted average price

*Common Stock repurchases*

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

**Off-Balance Sheet Arrangements**

As of September 30, 2013 and December 31, 2012, 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. Furthermore, as of September 30, 2013 and December 31, 2012, we had not guaranteed any obligations of any unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

**Critical Accounting Policies**

Our financial statements are prepared in conformity with GAAP. In preparing the financial statements, management is required to make various judgments, estimates and assumptions that affect the reported amounts. Changes in these estimates and assumptions could have a material effect on our financial statements. The following is a summary of our policies most affected by management's judgments, estimates and assumptions.

*Revenue Recognition:* Interest income is earned and recognized based on the unpaid 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 actual lives of the securities.

*Fair Value of Agency Securities:* We invest in Agency Securities representing interests in or obligations backed by pools of single-family fixed rate, hybrid adjustable rate and adjustable rate mortgage loans. The authoritative literature requires us to classify our investments as either trading, available for sale or held to maturity securities. Management determines the appropriate classifications of the securities