

ANNALY CAPITAL MANAGEMENT INC
Form 10-Q
August 07, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED: JUNE 30, 2012

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER: 1-13447

ANNALY CAPITAL MANAGEMENT, INC.
(Exact name of Registrant as specified in its Charter)

MARYLAND
(State or other jurisdiction of incorporation or organization)

22-3479661
(IRS Employer Identification No.)

1211 AVENUE OF THE AMERICAS, SUITE 2902
NEW YORK, NEW YORK
(Address of principal executive offices)

10036
(Zip Code)

(212) 696-0100
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all documents and 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" 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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:

| Class | Outstanding at August 7, 2012 |
|-------------------------------|-------------------------------|
| Common Stock, \$.01 par value | 974,721,170 |

ANNALY CAPITAL MANAGEMENT, INC.
FORM 10-Q
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PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(dollars in thousands, except share and per share amounts)

| ASSETS | June 30, 2012 (Unaudited) | December 31, 2011(1) |
|--|------------------------------|-------------------------|
| Cash and cash equivalents | \$924,374 | \$994,198 |
| Reverse repurchase agreements | 2,025,471 | 860,866 |
| Investments, at fair value: | | |
| U.S. Treasury Securities (including pledged assets of \$113,441 and \$352,820, respectively) | 1,998,363 | 928,547 |
| Securities borrowed | 1,465,327 | 928,732 |
| Agency mortgage-backed securities (including pledged assets of \$101,951,118 and \$90,406,535, respectively) | 118,500,649 | 104,251,055 |
| Agency debentures (including pledged assets of \$183,960 and \$567,383, respectively) | 1,250,506 | 889,580 |
| Investments in affiliates | 203,057 | 211,970 |
| Equity securities | - | 3,891 |
| Corporate debt, held for investment | 60,638 | 52,073 |
| Receivable for investments sold | 1,320,996 | - |
| Accrued interest and dividends receivable | 420,390 | 409,023 |
| Receivable from Prime Broker | 3,272 | 3,272 |
| Receivable for advisory and service fees (including from affiliates of \$17,434 and \$16,245, respectively) | 20,743 | 19,550 |
| Intangible for customer relationships (net of accumulated amortization of \$6,609 million and \$5,432, respectively) | 9,714 | 10,807 |
| Goodwill | 55,417 | 42,030 |
| Other derivative contracts, at fair value | 3,717 | 113 |
| Other assets | 41,937 | 24,295 |
| Total assets | \$128,304,571 | \$109,630,002 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| U.S. Treasury Securities sold, not yet purchased, at fair value | \$1,884,922 | \$826,912 |
| Repurchase agreements | 96,760,797 | 84,097,885 |
| Securities loaned, at fair value | 1,113,107 | 804,901 |
| Payable for investments purchased | 7,387,410 | 4,315,796 |
| Convertible Senior Notes | 1,245,915 | 539,913 |
| Accrued interest payable | 174,819 | 138,965 |
| Dividends payable | 535,898 | 552,806 |
| Interest rate swaps, at fair value | 2,822,264 | 2,552,687 |
| Accounts payable and other liabilities | 94,853 | 7,223 |
| Total liabilities | 112,019,985 | 93,837,088 |
| 6.00% Series B Cumulative Convertible Preferred Stock: | - | 32,272 |

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4,600,000 shares authorized, 0 and 1,331,849 shares issued and outstanding, respectively

Stockholders' Equity:

| | | |
|--|----------------|----------------|
| 7.875% Series A Cumulative Redeemable Preferred Stock: 7,412,500 authorized, issued and outstanding | 177,088 | 177,088 |
| 7.625% Series C Cumulative Redeemable Preferred Stock: 12,650,000 and 0 authorized, respectively, 12,000,000 and 0 issued and outstanding, respectively | 290,514 | - |
| Common stock, par value \$0.01 per share, 1,975,337,500 and 1,987,987,500 authorized, respectively, 974,684,401 and 970,161,647 issued and outstanding, respectively | 9,747 | 9,702 |
| Additional paid-in capital | 15,168,020 | 15,068,870 |
| Accumulated other comprehensive income (loss) | 3,413,320 | 3,008,988 |
| Accumulated deficit | (2,774,103) | (2,504,006) |
| Total stockholders' equity | 16,284,586 | 15,760,642 |
| Total liabilities, Series B Cumulative Convertible Preferred Stock and stockholders' equity | \$ 128,304,571 | \$ 109,630,002 |

(1) Derived from the audited consolidated financial statements at December 31, 2011.

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(dollars in thousands, except share and per share amounts)
(Unaudited)

| | For the Quarter Ended June 30, | | For the Six Months Ended June 30, | |
|---|--------------------------------|-----------|-----------------------------------|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| Interest income: | | | | |
| Investments | \$876,229 | \$948,703 | \$1,727,188 | \$1,786,583 |
| U.S. Treasury Securities | 7,397 | 6,497 | 8,815 | 11,322 |
| Securities loaned | 2,698 | 1,868 | 5,216 | 3,211 |
| Total interest income | 886,324 | 957,068 | 1,741,219 | 1,801,116 |
| Interest expense: | | | | |
| Repurchase agreements | 139,579 | 100,164 | 253,493 | 202,766 |
| Convertible Senior Notes | 18,965 | 6,900 | 33,692 | 13,667 |
| U.S. Treasury Securities sold, not yet purchased | 5,801 | 4,772 | 8,445 | 9,758 |
| Securities borrowed | 2,098 | 1,484 | 4,158 | 2,585 |
| Total interest expense | 166,443 | 113,320 | 299,788 | 228,776 |
| Net interest income | 719,881 | 843,748 | 1,441,431 | 1,572,340 |
| Other income (loss): | | | | |
| Investment advisory and other fee income | 21,929 | 20,710 | 42,695 | 37,917 |
| Net gains (losses) on sales of Agency mortgage-backed securities and debentures | 94,837 | 7,336 | 175,136 | 34,521 |
| Dividend income from affiliates | 6,621 | 8,230 | 14,142 | 14,527 |
| Net gains (losses) on trading assets | 1,105 | (5,712) | 6,361 | 13,100 |
| Net unrealized gain (losses) on interest-only Agency mortgage-backed securities | (26,103) | 276 | 4,774 | 276 |
| Income (expense) from underwriting | (8) | (77) | (16) | 2,827 |
| Subtotal | 98,381 | 30,763 | 243,092 | 103,168 |
| Realized gains (losses) on interest rate swaps(1) | (222,002) | (216,760) | (441,342) | (422,908) |
| Realized gains (losses) on termination of interest rate swaps | - | - | (2,385) | - |
| Unrealized gains (losses) on interest rate swaps | (611,215) | (466,943) | (269,576) | (297,635) |
| Subtotal | (833,217) | (683,703) | (713,303) | (720,543) |
| Total other income (loss) | (734,836) | (652,940) | (470,211) | (617,375) |
| Expenses: | | | | |
| Compensation expense | 53,536 | 49,752 | 112,550 | 94,282 |
| Other general and administrative expenses | 11,012 | 7,477 | 19,905 | 14,774 |
| Total expenses | 64,548 | 57,229 | 132,455 | 109,056 |
| Income (loss) before income taxes and income from equity method investment in affiliate | (79,503) | 133,579 | 838,765 | 845,909 |

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| | | | | |
|--|-------------|-------------|---------------|-------------|
| Income taxes | (11,656) | (12,762) | (28,118) | (26,337) |
| Loss from equity method investment in affiliate | - | - | - | 1,140 |
| Net income (loss) | (91,159) | 120,817 | 810,647 | 820,712 |
| Dividends on preferred stock | 6,508 | 4,267 | 10,446 | 8,534 |
| Net income (loss) available (related) to common shareholders | \$(97,667) | \$116,550 | \$800,201 | \$812,178 |
| Net income (loss) available (related) per share to common shareholders: | | | | |
| Basic | \$(0.10) | \$0.14 | \$0.82 | \$1.03 |
| Diluted | \$(0.10) | \$0.14 | \$0.78 | \$1.00 |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 974,555,392 | 822,623,370 | 973,141,546 | 787,172,527 |
| Diluted | 974,555,392 | 827,754,731 | 1,052,888,301 | 827,622,301 |
| Dividends Declared Per Share of Common Stock | \$0.55 | \$0.65 | \$1.10 | \$1.27 |
| Net income (loss) | \$(91,159) | \$120,817 | 810,647 | \$820,712 |
| Other comprehensive income (loss): | | | | |
| Unrealized gains (losses) on available-for-sale securities | 741,727 | 1,047,639 | 579,468 | 905,412 |
| Unrealized losses on interest rate swaps | - | - | - | 14,298 |
| Reclassification adjustment for net (gains) losses included in net income (loss) | (94,837) | (7,336) | (175,136) | (34,521) |
| Other comprehensive income (loss) | 646,890 | 1,040,303 | 404,332 | 885,189 |
| Comprehensive income (loss) | \$555,731 | \$1,161,120 | \$1,214,979 | \$1,705,901 |

(1) Interest expense related to the Company's interest rate swaps is recorded in Realized gains (losses) on interest rate swaps on the Consolidated Statements of Comprehensive Income.

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(dollars in thousands, except per share data)
(Unaudited)

| | 7.875% Series A Cumulative Redeemable Preferred Stock | 7.625% Series C Cumulative Redeemable Preferred Stock | Common Stock Par Value | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Accumulated Deficit | Total |
|--|--|--|---------------------------------|----------------------------------|---|------------------------|---------------|
| BALANCE, DECEMBER 31, 2010 | \$ 177,088 | - | \$ 6,316 | \$ 9,175,245 | \$ 1,164,642 | \$ (658,391) | \$ 9,864,900 |
| Net income (loss) | - | - | - | - | - | 820,712 | 820,712 |
| Other comprehensive income (loss) | - | - | - | - | 885,189 | - | 885,189 |
| Exercise of stock options | - | - | 5 | 6,107 | - | - | 6,112 |
| Stock option expense and long-term compensation expense | - | - | 3 | 2,456 | - | - | 2,459 |
| Conversion of Series B cumulative preferred stock | - | - | - | 73 | - | - | 73 |
| Net proceeds from direct purchase and dividend reinvestment | - | - | 261 | 455,445 | - | - | 455,706 |
| Net proceeds from follow-on offering | - | - | 1,725 | 2,939,686 | - | - | 2,941,411 |
| Preferred Series A dividends declared \$0.984 per share | - | - | - | - | - | (7,298) | (7,298) |
| Preferred Series B dividends declared \$0.750 per share | - | - | - | - | - | (1,237) | (1,237) |
| Common dividends declared, \$1.27 per share | - | - | - | - | - | (1,038,665) | (1,038,665) |
| BALANCE, JUNE 30, 2011 | \$ 177,088 | - | \$ 8,310 | \$ 12,579,012 | \$ 2,049,831 | \$ (884,879) | \$ 13,929,362 |

| | | | | | | | |
|---|------------|---------|----------|---------------|--------------|----------------|---------------|
| BALANCE, DECEMBER 31, 2011 | \$ 177,088 | - | \$ 9,702 | \$ 15,068,870 | \$ 3,008,988 | \$ (2,504,006) | \$ 15,760,642 |
| Net income (loss) | - | - | - | - | - | 810,647 | 810,647 |
| Other comprehensive income (loss) | - | - | - | - | 404,332 | - | 404,332 |
| Exercise of stock options | - | - | 4 | 5,387 | - | - | 5,391 |
| Stock option expense and long-term compensation expense | - | - | - | 2,860 | - | - | 2,860 |
| Conversion of Series B cumulative preferred stock | - | - | 40 | 32,232 | - | - | 32,272 |
| Net proceeds from direct purchase and dividend reinvestment | - | - | 1 | 844 | - | - | 845 |
| Contingent beneficial conversion feature on 4% | - | - | - | - | - | - | - |
| Convertible Senior Notes | - | - | - | 46,341 | - | - | 46,341 |
| Equity component on 5% Convertible Senior Notes | - | - | - | 11,717 | - | - | 11,717 |
| Offering expenses | - | - | - | (231) | - | - | (231) |
| Net proceeds from 7.625% Series C Cumulative Redeemable Preferred Stock offering | - | 290,514 | - | - | - | - | 290,514 |
| Preferred Series A dividends declared \$0.984 per share | - | - | - | - | - | (7,298) | (7,298) |
| Preferred Series B dividends declared \$0.375 per share | - | - | - | - | - | (289) | (289) |
| Preferred Series C dividends declared \$0.238 per share | - | - | - | - | - | (2,859) | (2,859) |
| Common dividends declared, \$1.10 per | - | - | - | - | - | (1,070,298) | (1,070,298) |

share

BALANCE, JUNE

| | | | | | | | |
|----------|------------|------------|----------|---------------|--------------|----------------|---------------|
| 30, 2012 | \$ 177,088 | \$ 290,514 | \$ 9,747 | \$ 15,168,020 | \$ 3,413,320 | \$ (2,774,103) | \$ 16,284,586 |
|----------|------------|------------|----------|---------------|--------------|----------------|---------------|

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

(Unaudited)

| | For the Quarters Ended | | For the Six Months Ended | |
|---|------------------------|---------------|--------------------------|---------------|
| | June 30, 2012 | June 30, 2011 | June 30, 2012 | June 30, 2011 |
| Cash flows from operating activities: | | | | |
| Net income (loss) | \$(91,159 |) \$120,817 | \$810,647 | \$820,712 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | | |
| Amortization of Investment premiums and discounts, net | 302,769 | 126,501 | 583,105 | 301,244 |
| Amortization of intangibles | 633 | 469 | 1,224 | 835 |
| Amortization of deferred expenses | 1,838 | 900 | 2,738 | 1,800 |
| Amortization of contingent beneficial conversion feature and equity component on convertible senior notes | 6,232 | - | 14,060 | - |
| Net (gains) losses on sales of Agency mortgage-backed securities and debentures | (94,837 |) (7,336 |) (175,136 |) (34,521 |
| Stock option and long-term compensation expense | 1,011 | 1,197 | 2,860 | 2,459 |
| Unrealized (gains) losses on interest rate swaps | 611,215 | 466,943 | 269,576 | 297,635 |
| Net unrealized (gains) losses on interest-only Agency mortgage-backed securities | 26,103 | (276 |) (4,774 |) (276 |
| Net (gains) losses on trading assets | (1,105 |) 5,712 | (3,976 |) (13,100 |
| Gain on investment in affiliate, equity method | - | - | - | (98 |
| Proceeds from repurchase agreements from RCap | 213,985,974 | 260,778,820 | 341,038,916 | 563,508,986 |
| Payments on repurchase agreements from RCap | (214,067,318) | (264,821,370) | (336,809,273) | (562,783,026) |
| Proceeds from reverse repurchase agreements to RCap | 130,785,187 | 48,545,230 | 185,681,953 | 104,692,314 |
| Payments on reverse repurchase agreements to RCap | (130,254,085) | (47,785,998 |) (186,831,887) | (104,274,988) |
| Proceeds from reverse repurchase agreements to Shannon | 129,848 | 7,045 | 223,740 | 7,045 |
| Payments on reverse repurchase agreements to Shannon | (145,820 |) (12,073 |) (238,411 |) (12,073 |
| Proceeds from securities borrowed | 12,741,368 | 1,459,729 | 19,424,651 | 2,452,768 |
| Payments on securities borrowed | (13,084,242 |) (1,610,944 |) (19,961,246 |) (2,756,021 |
| Proceeds from securities loaned | 33,856,914 | 1,328,957 | 65,859,868 | 2,504,167 |
| Payments on securities loaned | (33,620,656 |) (1,241,479 |) (65,551,662 |) (2,274,678 |
| Proceeds from U.S. Treasury Securities | 15,289,185 | 4,674,592 | 31,097,679 | 12,797,913 |
| Payments on U.S. Treasury Securities | (17,754,440 |) (4,691,219 |) (31,840,754 |) (12,889,942 |
| Net payments on derivatives | (18,309 |) (1,803 |) (17,460 |) (2,774 |
| Net change in: | | | | |
| Other assets | 8,072 | 64,740 | 2,154 | 685 |

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| | | | | |
|---|---------------|---------------|---------------|---------------|
| Accrued interest and dividend receivable | (1,562) | 8,027 | (12,130) | (40,644) |
| Advisory and service fees receivable | (1,135) | (3,035) | (1,193) | (3,494) |
| Accrued interest payable | 45,711 | 9,652 | 35,854 | 6,987 |
| Accounts payable and other liabilities | 36,926 | (192) | 87,630 | 69,974 |
| Net cash provided by (used in) operating activities | (1,305,682) | (2,576,394) | 3,688,753 | 2,379,889 |
| Cash flows from investing activities: | | | | |
| Payments on purchases of Agency mortgage-backed securities and debentures | (18,020,975) | (5,632,236) | (38,120,124) | (32,289,712) |
| Proceeds from sales of Agency mortgage-backed securities and debentures | 5,145,156 | 2,035,385 | 9,915,497 | 5,433,231 |
| Principal payments on Agency mortgage-backed securities | 7,877,543 | 3,804,919 | 15,254,031 | 9,354,570 |
| Proceeds from Agency debentures called | 698,523 | 23,352 | 850,163 | 617,598 |
| Principal payments on corporate debt | 125 | 687 | 1,460 | 1,155 |
| Net gains (losses) on other derivative securities | - | (3,480) | - | 11,518 |
| Earn out payment | - | - | (13,387) | - |
| Payments on purchase of corporate debt | (9,900) | (7,425) | (9,900) | (7,425) |
| Purchase of investment in affiliate | - | (57,500) | - | (57,500) |
| Purchase of customer relationships | - | (3,555) | - | (3,555) |
| Proceeds from sales of equity securities | 4,048 | - | 4,048 | - |
| Net cash provided by (used in) investing activities | (4,305,480) | 160,147 | (12,118,212) | (16,940,120) |
| Cash flows from financing activities: | | | | |
| Proceeds from repurchase agreements | 84,206,888 | 62,388,848 | 167,136,997 | 127,836,494 |
| Principal payments on repurchase agreements | (79,085,612) | (59,883,047) | (158,703,728) | (115,648,826) |
| Proceeds from exercise of stock options | 3,549 | 3,675 | 5,391 | 6,112 |
| Net proceeds from Series C Preferred offering | 290,514 | - | 290,514 | - |
| Net proceeds from issuance of 5% Convertible Senior Notes offering | 727,500 | - | 727,500 | - |
| Net proceeds from direct purchases and dividend reinvestments | 845 | 454,564 | 845 | 455,706 |
| Net (payment) proceeds from follow-on offerings | - | - | (231) | 2,941,411 |
| Dividends paid | (540,909) | (502,961) | (1,097,653) | (911,448) |
| Net cash provided by (used in) financing activities | 5,602,775 | 2,461,079 | 8,359,635 | 14,679,449 |
| Net (decrease) increase in cash and cash equivalents | (8,387) | 44,832 | (69,824) | 119,218 |
| Cash and cash equivalents, beginning of period | 932,761 | 357,012 | 994,198 | 282,626 |
| Cash and cash equivalents, end of period | \$924,374 | \$401,844 | \$924,374 | \$401,844 |

Supplemental disclosure of cash flow information:

| | | | | |
|--|-------------|-------------|-------------|-------------|
| Interest received | \$1,186,292 | \$1,089,657 | \$2,311,295 | \$2,061,037 |
| Dividends received | \$7,521 | \$7,338 | \$15,804 | \$14,940 |
| Fees received | \$20,794 | \$17,675 | \$41,502 | \$34,423 |
| Interest paid (excluding interest paid on interest rate swaps) | \$115,764 | \$105,423 | \$249,863 | \$228,844 |
| Net interest paid on interest rate swaps | \$220,738 | \$215,005 | \$441,353 | \$415,853 |

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| | | | | |
|--|-------------|-------------|-------------|-------------|
| Taxes paid | \$7,766 | \$3,275 | \$29,167 | \$25,676 |
| Noncash investing activities: | | | | |
| Receivable for Investments sold | \$1,320,996 | \$40,751 | \$1,320,996 | \$40,751 |
| Payable for Investments purchased | \$7,387,410 | \$4,824,618 | \$7,387,410 | \$4,824,618 |
| Net change in unrealized loss on available-for-sale securities and interest rate swaps, net of reclassification adjustment | \$646,890 | \$1,040,303 | \$404,332 | \$885,189 |
| Noncash financing activities: | | | | |
| Dividends declared, not yet paid | \$535,898 | \$539,970 | \$535,898 | \$539,970 |
| Conversion of Series B cumulative preferred stock | - | \$24 | \$32,272 | \$73 |
| Contingent beneficial conversion feature on 4% Convertible Senior Notes | \$23,020 | - | \$46,341 | - |
| Equity component of 5% Convertible Senior Notes | \$11,717 | - | \$11,717 | - |

See notes to consolidated financial statements.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Capital Management, Inc. (“Annaly” or the “Company”) was incorporated in Maryland on November 25, 1996. The Company commenced its operations of purchasing and managing an investment portfolio of mortgage-backed securities on February 18, 1997, upon receipt of the net proceeds from the private placement of equity capital, and completed its initial public offering on October 14, 1997. The Company is a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended. Fixed Income Discount Advisory Company (“FIDAC”) is a registered investment advisor and is a wholly owned taxable REIT subsidiary of the Company. On June 27, 2006, the Company made a majority equity investment in an affiliated investment fund (the “Fund”), which is now wholly owned by the Company. During the third quarter of 2008, the Company formed RCap Securities, Inc. (“RCap”). RCap was granted membership in the Financial Industry Regulatory Authority (“FINRA”) on January 26, 2009, and operates as a broker-dealer. RCap is a wholly owned taxable REIT subsidiary of the Company. On October 31, 2008, the Company acquired Merganser Capital Management, Inc. (“Merganser”). Merganser is a registered investment advisor and is a wholly owned taxable REIT subsidiary of the Company. In 2010, the Company established Shannon Funding LLC (“Shannon”), which provides warehouse financing to residential mortgage originators in the United States. In 2010, the Company also established Charlesfort Capital Management LLC (“Charlesfort”), which engages in corporate middle market lending transactions. In 2011, FIDAC established FIDAC Europe Limited (“FIDAC Europe”), which provides advice on commercial real estate transactions, including sale-leaseback and single tenant net leased properties across Europe. In 2011, the Company established FIDAC FSI LLC (“FIDAC FSI”), which invests in trading securities.

A summary of the Company’s significant accounting policies follows:

Basis of Accounting

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”). In the opinion of management, all adjustments considered necessary for a fair presentation of the Company's consolidated financial position, results of operations and cash flows have been included and are of a normal and recurring nature.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, FIDAC, FIDAC Europe, FIDAC FSI, Merganser, RCap, Shannon, Charlesfort and the Fund. All intercompany balances and transactions have been eliminated in consolidation.

Beginning with the Company’s consolidated financial statements for the six month period ending June 30, 2011, interest expense related to interest rate swaps for prior periods has been reclassified to conform to the current presentation (i.e., presented in Other income (loss) as Realized gains (losses) on interest rate swaps).

Cash and Cash Equivalents - Cash and cash equivalents include cash on hand and cash held in money market funds on an overnight basis.

Reverse Repurchase Agreements – The Company through Rcap enters into reverse repurchase agreements as part of the RCap’s matched book trading activity. Reverse repurchase agreements are recorded on trade date at the contract

amount and are collateralized by mortgage-backed or other securities. Margin calls are made by RCap as necessary based on the daily valuation of the underlying collateral as compared to the contract price. The Company generates income from the spread between what is earned on the reverse repurchase agreements and what is paid on the matched repurchase agreements. The Company's policy is to obtain possession of collateral with a market value in excess of the principal amount loaned under reverse repurchase agreements. To ensure that the market value of the underlying collateral remains sufficient, collateral is valued daily, and the Company will require counterparties to deposit additional collateral, when necessary. All reverse repurchase activities are transacted under master repurchase agreements that give the Company the right, in the event of default, to liquidate collateral held and to offset receivables and payables with the same counterparty.

Securities borrowed and loaned transactions – RCap records securities borrowed and loaned transactions at fair value. Securities borrowed transactions require RCap to provide the counterparty with collateral in the form of cash. RCap receives collateral in the form of cash for securities loaned transactions. For these transactions, the fees received or paid by RCap are recorded as interest income or expense, respectively. On a daily basis, market value changes of securities borrowed or loaned against the collateral value and RCap may require counterparties to deposit additional collateral or may require RCap to return collateral pledged, when appropriate.

U.S. Treasury Securities — RCap’s trades in U.S. Treasury securities consist of long and short positions on U.S Treasury notes and bonds. U.S. Treasury securities are classified as trading investments and are recorded on the trade date at cost. Changes in fair value are reflected in the Company’s Consolidated Statement of Comprehensive Income. Generally RCap does not hold the U.S. Treasury bills, notes and bonds to maturity and realizes gains and losses from trading those positions. Interest income or expense on U.S Treasury notes and bonds is accrued based on the outstanding principal amount of those investments and their stated terms.

Investment Securities –Agency mortgage-backed securities, Agency debentures, and corporate debt are referred to herein as “Investment Securities.” Although the Company generally intends to hold most of its Investment Securities until maturity, it may, from time to time, sell any of its Investment Securities as part of its overall management of its portfolio. Investment Securities classified as available-for-sale are reported at fair values estimated by management that are compared to independent sources for reasonableness, with unrealized gains and losses reported as a component of stockholders’ equity. Investment Securities transactions are recorded on the trade date. Realized gains and losses on sales of Investment Securities are determined using the average cost method.

On April 1, 2011, the Company elected the fair value option for Agency interest-only mortgage-backed securities acquired on or after such date. These Agency interest-only mortgage-backed securities represent the Company’s right to receive a specified proportion of the contractual interest flows of specific Agency mortgaged-backed securities. Agency Interest-only mortgage-backed securities acquired on or after April 1, 2011 are measured at fair value through earnings in the Company’s Consolidated Statements of Comprehensive Income. The interest-only securities are included in Agency mortgage-backed securities, at fair value on the accompanying Consolidated Statements of Financial Condition.

Agency Mortgage-Backed Securities and Agency Debentures – The Company invests primarily in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans, and certificates guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae (collectively, “Agency mortgage-backed securities”). The Company also invests in Agency debentures issued by Federal Home Loan Bank (“FHLB”), Freddie Mac, and Fannie Mae.

Interest income from coupon payments is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized into interest income over the projected lives of the securities using the interest method. The Company’s policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, consensus prepayment speeds, and current market conditions. Adjustments are made for actual prepayment activity.

Equity Securities – The Company invests in equity securities that are classified as available-for-sale or trading. Equity securities classified as available-for-sale are reported at fair value, based on market quotes, with unrealized gains and losses reported as a component of stockholders’ equity. Equity securities classified as trading are reported at fair value, based on market quotes, with unrealized gains and losses reported in the Consolidated Statement of Comprehensive Income. Dividends are recorded in earnings based on the declaration date.

Other-Than-Temporary Impairment – Management evaluates available-for-sale securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. The Company determines if it (1) has the intent to sell the securities, (2) is more likely than not that it will be required to sell the securities before recovery, or (3) does not expect to recover the entire amortized cost basis of the securities. Further, the security is analyzed for credit loss (the difference between the present value of cash flows expected to be collected and the amortized cost basis). The credit loss, if any, will then be recognized in the Consolidated Statements of Comprehensive Income, while the balance of losses related to other factors will be recognized as a component of stockholders' equity. There was no other-than-temporary impairment for the quarters and six months ended June 30, 2012 and 2011.

Derivative Instruments – The Company accounts for interest rate swaps at fair value as either assets or liabilities on the Consolidated Statements of Financial Condition. Changes in the fair value of interest rate swaps are recognized in earnings. The Company uses interest rate swaps to manage its exposure to changing interest rates on its repurchase agreements. Net payments on interest rate swaps are included in the Consolidated Statements of Cash Flows as a component of operating activities.

The Company elected to net, by counterparty, the fair value of interest rate swap contracts. These contracts contain legally enforceable provisions that allow for netting or setting off swap receivables and payables with each counterparty and, therefore, the fair value of those swap contracts are netted by counterparty. The credit support annex provisions of the Company’s interest rate swap contracts allow the parties to mitigate their credit risk by requiring the party which is out of the money to post collateral. As the Company elects to net by counterparty the fair value of interest rate swap contracts, it also nets by counterparty any collateral exchanged as part of the interest rate swap contracts. Substantially all collateral is non-cash collateral under these contracts. In addition, the Company’s agreements with certain of its counterparties with whom it has both interest rate swap contracts and master repurchase agreements contain legally enforceable provisions that allow for netting or setting off, on an aggregate basis, all receivables, payables and collateral postings required under both the interest rate swap contract and the master repurchase agreement with respect to each such counterparty.

RCap primarily enters into exchange traded U.S. interest rate, equity index, and FX futures and options contracts as well as German interest rate futures contracts for speculative or hedging purposes. RCap maintains a margin account which is settled daily with futures and options commission merchants. Changes in the unrealized gains or losses on the futures and options contracts are reflected in the Company’s Consolidated Statements of Comprehensive Income. Unrealized gains (losses) are excluded from net income (loss) in arriving at cash flows from operating activities in the Consolidated Statements of Cash Flows.

Credit Risk – The Company has limited its exposure to credit losses on its portfolio of Agency mortgage-backed securities by only purchasing securities issued by Freddie Mac, Fannie Mae or Ginnie Mae and Agency debentures issued by the FHLB, Freddie Mac and Fannie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae Agency mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on Ginnie Mae Agency mortgage-backed securities are backed by the full faith and credit of the U.S. government. Principal and interest on Agency debentures are guaranteed by the agency issuing the debenture. Substantially all of the Company’s Investment Securities have an actual or implied “AAA” rating. The Company faces credit risk on the portions of its portfolio which are not Agency mortgage-backed securities and Agency debentures.

Market Risk - Weakness in the mortgage market may adversely affect the performance and market value of the Company’s investments. This could negatively impact the Company’s net book value. Furthermore, if many of the Company’s lenders are unwilling or unable to provide additional financing, the Company could be forced to sell its Investment Securities at an inopportune time when prices are depressed. The Company does not anticipate having difficulty converting its assets to cash or extending financing terms due to the fact that its Agency mortgage-backed securities and Agency debentures have an actual or implied “AAA” rating and principal payment is guaranteed by Freddie Mac, Fannie Mae, or Ginnie Mae.

Repurchase Agreements - The Company finances the acquisition of a significant portion of its Agency mortgage-backed securities with repurchase agreements. None of the Company’s repurchase agreements are accounted for as components of linked transactions. The Company examines each of the specified criteria in ASC 860-10-40-42 and ASC 860-10-40-44 at the inception of each transaction and has determined that each of the financings meet the specified criteria in this guidance. As a result, the Company separately accounts for the financial assets and related repurchase financings in the accompanying consolidated financial statements.

Reverse repurchase agreements and repurchase agreements with the same counterparty and the same maturity are presented net in the Consolidated Statements of Financial Condition when the terms of the agreements permit netting. The Company reports cash flows on repurchase agreements as financing activities in the Consolidated Statements of Cash Flows. The Company reports cash flows on repurchase agreements entered into by RCap and Shannon as operating activities in the Consolidated Statements of Cash Flows.

Convertible Senior Notes – The Company records the 4% Convertible Senior Notes and 5% Convertible Senior Notes (collectively, the “Convertible Senior Notes”) at their contractual amounts, adjusted by the effects of a beneficial conversion feature and a contingent beneficial conversion feature. The Convertible Senior Notes have a conversion price adjustment feature that is evaluated at the time of the conversion price adjustment. A contingent beneficial conversion feature may be recognized as a result of adjustments to the conversion price for dividends declared. The Company determined the intrinsic value of a contingent beneficial conversion feature. This intrinsic value is included in “Additional paid in capital” on the Company’s Consolidated Statements of Financial Condition and reduces the liability associated with the Convertible Senior Notes.

Cumulative Convertible Preferred Stock - The Series B Cumulative Convertible Preferred Stock (the “Series B Preferred Stock”) contains fundamental change provisions that allow the holder to redeem the Series B Preferred Stock for cash if certain events occur. As redemption under these provisions is not solely within the Company’s control, for the periods that the Company had Series B Preferred Stock issued and outstanding, the Company classified the Series B Preferred Stock as temporary equity in the accompanying Consolidated Statements of Financial Condition. As of June 30, 2012, there were no shares outstanding of Series B Preferred Stock.

Income Taxes - The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the “Code”), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and its direct and indirect subsidiaries, FIDAC, FIDAC Europe, Merganser and RCap, have made separate joint elections to treat these subsidiaries as taxable REIT subsidiaries. As such, each of the taxable REIT subsidiaries are taxable as a domestic C corporation and subject to federal, state, and local income taxes based upon their taxable income.

The provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 740, Income Taxes, clarify the accounting for uncertainty in income taxes recognized in financial statements and prescribe a recognition threshold and measurement attribute for tax positions taken or expected to be taken on a tax return. ASC 740 also requires that interest and penalties related to unrecognized tax benefits be recognized in the financial statements. The Company does not have any unrecognized tax benefits that would affect its financial position. Thus, no accruals for penalties and interest were necessary as of June 30, 2012.

Goodwill and Intangible Assets - The Company’s acquisitions of FIDAC, Merganser, and FIDAC Europe were accounted for using the acquisition method. Under the acquisition method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. The costs of FIDAC and Merganser were allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of purchase price over the fair value of the net assets acquired was recognized as goodwill. In addition, FIDAC Europe acquired a customer relationship after its formation. Goodwill and intangible assets are periodically (but not less frequently than annually) reviewed for potential impairment. Intangible assets with an estimated useful life are amortized over the expected life. During the quarters and six months ended June 30, 2012 and 2011, there were no impairment losses recognized related to goodwill and intangible assets.

Stock Based Compensation - The Company is required to measure and recognize in the consolidated financial statements the compensation cost relating to share-based payment transactions. The Company recognizes compensation expense on a straight-line basis over the requisite service period for the entire award.

Use of Estimates - The preparation of the consolidated financial statements in conformity with U.S. 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. All assets classified as trading or available-for-sale and interest rate swaps are reported at their estimated fair value, based on market prices. The Company's policy is to obtain fair values from one or more independent sources to compare to internal prices for reasonableness. Actual results could differ from those estimates.

A Summary of Recent Accounting Pronouncements Follows:

Presentation

Balance Sheet (Topic 210)

On December 23, 2011, the FASB released Accounting Standards Update (“ASU”) 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. Under this update, the Company will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and transactions subject to an agreement similar to a master netting arrangement. The scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements and securities borrowing and securities lending arrangements. This disclosure is intended to enable financial statement users to understand the effect of such arrangements on the Company’s financial position. The objective of this update is to support further convergence between U.S. GAAP and International Financial Reporting Standards (“IFRS”). This update is effective for annual reporting periods beginning on or after January 1, 2013. This update is expected to result in additional disclosure.

Comprehensive Income (Topic 220)

In June 2011, the FASB released ASU 2011-05 Comprehensive Income: Presentation of Comprehensive Income, which attempts to improve the comparability, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income (“OCI”). ASU 2011-05 requires that all non-owner changes in stockholders’ equity be presented either in a single continuous statement of net income and comprehensive income or two separate consecutive statements. Either presentation requires the presentation on the face of the financial statements any reclassification adjustments for items that are reclassified from OCI to net income in the statements. There is no change in what must be reported in OCI or when an item of OCI must be reclassified to net income. This update is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. This update resulted in additional disclosure, but had no significant effect on the Company’s consolidated financial statements.

On December 23, 2011, the FASB issued ASU 2011-12, Comprehensive Income: Deferral of Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income In ASU No. 2011-05, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated OCI. This was done to allow the FASB time to re-deliberate the presentation on the face of the financial statements the effects of reclassifications out of accumulated OCI on the components of net income and OCI. No other requirements under ASU 2011-05 are affected by ASU 2011-12. During June 2012, the FASB tentatively decided not to require presentation of reclassification adjustments out of accumulated other comprehensive income on the face of the financial statements and to propose new disclosures instead.

Assets

Intangibles – Goodwill and Other (Topic 350)

In September 2011, the FASB released ASU 2011-08, Intangibles-Goodwill and Other: Testing Goodwill for Impairment, which allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. The objective of the update is to simplify how entities test goodwill for impairment. Under this update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after

December 15, 2011. This update is not expected to have a significant impact on the Company's consolidated financial statements.

Broad Transactions

Fair Value Measurements and Disclosures (Topic 820)

In May 2011, the FASB released ASU 2011-04 Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS, further converging U.S. GAAP and IFRS by providing common fair value measurement and disclosure requirements. FASB made changes to the fair value measurement guidance, which include: 1) prohibiting the inclusion of block discounts in all fair value measurements, not just Level 1 measurements, 2) adding guidance on when to include other premiums and discounts in fair value measurements, 3) clarifying that the concepts of “highest and best use” and “valuation premise” apply only when measuring the fair value of non-financial assets and 4) adding an exception that allows the measurement of a group of financial assets and liabilities with offsetting risks (e.g., a portfolio of derivative contracts) at their net exposure to a particular risk if certain criteria are met. ASU 2011-04 also requires additional disclosure related to items categorized as Level 3 in the fair value hierarchy, including a description of the processes for valuing these assets, providing quantitative information about the significant unobservable inputs used to measure fair value, and in certain cases, explaining the sensitivity of the fair value measurements to changes in unobservable inputs. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011. The Company does not hold any Level 3 assets and therefore, this update has no significant effect on the Company’s consolidated financial statements.

Transfers and Servicing (Topic 860)

In April 2011, the FASB issued ASU 2011-03, Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements. In a typical repurchase agreement transaction, an entity transfers financial assets to the counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. Previous to this update, one of the factors in determining whether sale treatment could be used was whether the transferor maintained effective control of the transferred assets and in order to do so, the transferor must have the ability to repurchase such assets. In connection with the issuance of ASU 2011-03, the FASB concluded that the assessment of effective control should focus on a transferor’s contractual rights and obligations with respect to transferred financial assets, rather than whether the transferor has the practical ability to perform in accordance with those rights or obligations. ASU 2011-03 removes the transferor’s ability criterion from consideration of effective control. This update is effective for the first interim or annual period beginning on or after December 15, 2011. As the Company records repurchase agreements as secured borrowings and not sales, this update has no significant effect on the Company’s consolidated financial statements.

Financial Services – Investment Companies (Topic 946)

In October 2011, the FASB issued a proposed ASU 2011-20, Financial Services-Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements, which would amend the criteria in Topic 946 for determining whether an entity qualifies as an investment company. As proposed, this ASU would affect the measurement, presentation and disclosure requirements for Investment Companies, as defined, amend the investment company definition in ASC 946, and remove the current exemption for Real Estate Investment Trusts from this topic. If promulgated in its current form, this proposal may result in a material modification to the presentation of the Company’s consolidated financial statements. The Company is monitoring developments related to this proposal and is evaluating the effects it would have on the Company’s consolidated financial statements.

2. AGENCY MORTGAGE-BACKED SECURITIES

The following tables present the Company's available-for-sale Agency mortgage-backed securities portfolio as of June 30, 2012 and December 31, 2011 which were carried at their fair value:

| June 30, 2012 | Freddie Mac | Fannie Mae | Ginnie Mae | Total Mortgage- Backed Securities |
|--|------------------------|-----------------------------|-----------------------------|--|
| | (dollars in thousands) | | | |
| Agency mortgage-backed securities, par value | \$42,260,231 | \$68,048,738 | \$358,111 | \$110,667,080 |
| Unamortized discount | (12,422) | (16,835) | (394) | (29,651) |
| Unamortized premium | 1,645,675 | 2,833,531 | 17,567 | 4,496,773 |
| Amortized cost | 43,893,484 | 70,865,434 | 375,284 | 115,134,202 |
| Gross unrealized gains | 1,222,311 | 2,246,757 | 22,086 | 3,491,154 |
| Gross unrealized losses | (13,309) | (111,130) | (268) | (124,707) |
| Estimated fair value | \$45,102,486 | \$73,001,061 | \$397,102 | \$118,500,649 |
| | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Estimated Fair Value |
| | (dollars in thousands) | | | |
| Adjustable rate | \$7,603,346 | \$354,493 | \$(3,254) | \$7,954,585 |
| Fixed rate | 107,530,856 | 3,136,661 | (121,453) | 110,546,064 |
| Total | \$115,134,202 | \$3,491,154 | \$(124,707) | \$118,500,649 |
| December 31, 2011 | Freddie Mac | Fannie Mae | Ginnie Mae | Total Mortgage- Backed Securities |
| | (dollars in thousands) | | | |
| Agency mortgage-backed securities, par value | \$34,395,542 | \$63,066,372 | \$500,968 | \$97,962,882 |
| Unamortized discount | (9,874) | (13,632) | (399) | (23,905) |
| Unamortized premium | 1,139,881 | 2,205,138 | 15,949 | 3,360,968 |
| Amortized cost | 35,525,549 | 65,257,878 | 516,518 | 101,299,945 |
| Gross unrealized gains | 973,476 | 2,081,282 | 31,474 | 3,086,232 |
| Gross unrealized losses | (15,243) | (118,871) | (1,008) | (135,122) |
| Estimated fair value | \$36,483,782 | \$67,220,289 | \$546,984 | \$104,251,055 |
| | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Estimated Fair Value |
| | (dollars in thousands) | | | |

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| | | | | | |
|-----------------|---------------|-------------|------------|---|---------------|
| Adjustable rate | \$8,698,746 | \$345,642 | \$(3,188 |) | \$9,041,200 |
| Fixed rate | 92,601,199 | 2,740,590 | (131,934 |) | 95,209,855 |
| Total | \$101,299,945 | \$3,086,232 | \$(135,122 |) | \$104,251,055 |

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Actual maturities of Agency mortgage-backed securities are generally shorter than stated contractual maturities because actual maturities of Agency mortgage-backed securities are affected by the contractual lives of the underlying mortgages, periodic payments and prepayments of principal. The following table summarizes the Company's Agency mortgage-backed securities as of June 30, 2012 and December 31, 2011, according to their estimated weighted-average life classifications:

| Weighted-Average Life | June 30, 2012 | | December 31, 2011 | |
|---|------------------------|----------------|-------------------|----------------|
| | Fair Value | Amortized Cost | Fair Value | Amortized Cost |
| | (dollars in thousands) | | | |
| Less than one year | \$1,027,916 | \$1,018,120 | \$1,715,530 | \$1,697,101 |
| Greater than one year through five years | 115,316,496 | 111,995,752 | 97,344,791 | 94,534,782 |
| Greater than five years through ten years | 1,550,930 | 1,526,994 | 4,447,540 | 4,348,841 |
| Greater than 10 years | 605,307 | 593,336 | 743,194 | 719,221 |
| Total | \$118,500,649 | \$115,134,202 | \$104,251,055 | \$101,299,945 |

The weighted-average lives of the Agency mortgage-backed securities at June 30, 2012 and December 31, 2011 in the table above are based upon data provided through subscription-based financial information services, assuming constant principal prepayment rates to the reset date of each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loans, loan age, margin, volatility, and other factors. The actual weighted average lives of the Agency mortgage-backed securities could be longer or shorter than estimated.

The following table presents the gross unrealized losses and estimated fair value of the Company's Agency mortgage-backed securities by length of time that such securities have been in a continuous unrealized loss position at June 30, 2012 and December 31, 2011.

| | Unrealized Loss Position For: | | | | | |
|-------------------|-------------------------------|-------------------|----------------------|-------------------|----------------------|-------------------|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses |
| June 30, 2012 | \$1,637,378 | \$(101,373) | \$431,509 | \$(23,334) | \$2,068,887 | \$(124,707) |
| December 31, 2011 | \$1,087,552 | \$(118,593) | \$883,143 | \$(16,529) | \$1,970,695 | \$(135,122) |

The decline in value of these securities is solely due to market conditions and not the quality of the assets. Substantially all of the Agency mortgage-backed securities are "AAA" rated or carry an implied "AAA" rating. The investments are not considered to be other-than-temporarily impaired because the Company currently has the ability and intent to hold the investments to maturity or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of the investments, and it is not more likely than not that the Company will be required to sell the investments before recovery of the amortized cost bases, which may be maturity. Also, the Company is guaranteed payment of the principal amount of the securities by the respective issuing government agency.

During the quarter and six months ended June 30, 2012, the Company sold \$5.7 billion and \$10.9 billion of Agency mortgage-backed securities, respectively, resulting in a net realized gain of \$94.8 million and \$175.1 million, respectively. During the quarter and six months ended June 30, 2011, the Company sold \$1.6 billion and \$4.6 billion

of Agency mortgage-backed securities, respectively, resulting in a realized gain of \$5.9 million and \$26.8 million, respectively. Average cost is used for calculating gains or losses on securities sold.

Agency interest-only mortgage-backed securities represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance of specific Agency mortgage-backed securities. As of June 30, 2012, Agency interest-only mortgage-backed securities had net unrealized losses of \$110.5 million (consisting of net unrealized losses of \$75.8 million included in accumulated deficit and net unrealized losses of \$34.7 million included in other comprehensive income) and an amortized cost of \$527.2 million.

3. INVESTMENTS IN AFFILIATES, AVAILABLE FOR SALE EQUITY SECURITIES

Substantially all of the Company's available-for-sale equity securities are shares of Chimera Investment Corporation ("Chimera") and CreXus Investment Corp. ("CreXus") and are reported at fair value. The Company owned approximately 45.0 million shares of Chimera at June 30, 2012 and December 31, 2011 with a fair value of approximately \$106.2 million and \$112.9 million, respectively. At June 30, 2012 and December 31, 2011, the investment in Chimera had an unrealized loss of \$32.7 million and \$25.9 million, respectively. The Company owned approximately 9.5 million shares of CreXus at June 30, 2012 and December 31, 2011, with a fair value of approximately \$96.9 million and \$98.9 million, respectively. At June 30, 2012 and December 31, 2011, the investment in CreXus had an unrealized loss of \$28.5 million and \$26.5 million, respectively.

The Company has evaluated the near-term prospects of its investment in affiliates in relation to the severity and length of time of the impairment. Based on this evaluation, management has determined that its investment in affiliates is not considered to be other-than-temporarily impaired as of June 30, 2012 and December 31, 2011 as the Company has the intent and ability to retain its investments for a period of time sufficient to allow for any anticipated recovery in market value.

4. GOODWILL

Merganser's prior owners received an additional payment of \$13.4 million during the first quarter of 2012 relating to earn-out provisions in the merger agreement. This amount was recorded as additional goodwill.

5. FAIR VALUE MEASUREMENTS

The Company follows fair value guidance in accordance with U.S. GAAP to account for its financial instruments. The Company categorizes its financial instruments, based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument. Financial assets and liabilities recorded at fair value on the consolidated statements of financial condition or disclosed in the related notes are categorized based on the inputs to the valuation techniques as follows:

Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets and liabilities in active markets.

Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – inputs to the valuation methodology are unobservable and significant to overall fair value.

Agency mortgage-backed securities, Agency debentures and interest rate swaps are valued using quoted prices, including dealer quotes, or internally estimated prices for similar assets. The Company incorporates common market pricing methods, including a spread measurement to the Treasury curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period and expected life of the security in its estimates of fair value. Management ensures that current market conditions are reflected in its estimates of fair value. Management compares internal prices to independent third party sources and dealer quotes for reasonableness.

The fair value of securities loaned at fair value, U.S. Treasury securities, securities borrowed and loaned, investments in affiliates and equity investments are based on quoted prices in active markets.

| | Level 1 | Level 2 | Level 3 |
|--|--------------|------------------------|---------|
| At June 30, 2012 | | (dollars in thousands) | |
| Assets: | | | |
| U.S. Treasury Securities | \$ 1,998,363 | \$- | - |
| Securities borrowed | - | 1,465,327 | - |
| Agency mortgage-backed securities | - | 118,500,649 | - |
| Agency debentures | - | 1,250,506 | - |
| Investment in affiliates | 203,057 | - | - |
| Equity securities | - | - | - |
| Other derivative contracts | 3,717 | - | - |
| Liabilities: | | | |
| U.S. Treasury securities sold, not yet purchased | 1,884,922 | - | - |
| Interest rate swaps | - | 2,822,264 | - |
| Securities loaned | - | 1,113,107 | - |
| At December 31, 2011 | | (dollars in thousands) | |
| Assets: | | | |
| U.S. Treasury securities | \$928,547 | \$- | - |
| Securities borrowed | - | 928,732 | - |
| Agency mortgage-backed securities | - | 104,251,055 | - |
| Agency debentures | - | 889,580 | - |
| Investments in affiliates | 211,970 | - | - |
| Equity securities | 3,891 | - | - |
| Other derivative contracts | 113 | - | - |
| Liabilities: | | | |
| U.S. Treasury securities sold, not yet purchased | 826,912 | - | - |
| Interest rate swaps | - | 2,552,687 | - |
| Securities loaned | - | 804,901 | - |

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The following table summarized the estimated fair value for all financial assets and liabilities as of June 30, 2012 and December 31, 2011.

| | June 30, 2012 | | December 31, 2011 | |
|---|----------------|-------------|-------------------|-------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| (dollars in thousands) | | | | |
| Financial assets: | | | | |
| Cash and cash equivalents(1) | \$924,374 | \$924,374 | \$994,198 | \$994,198 |
| Reverse repurchase agreements(1) | 2,025,471 | 2,025,471 | 860,866 | 860,866 |
| U.S. Treasury Securities(2) | 1,998,363 | 1,998,363 | 928,547 | 928,547 |
| Securities borrowed(2) | 1,465,327 | 1,465,327 | 928,732 | 928,732 |
| Agency mortgage-backed securities | 118,500,649 | 118,500,649 | 104,251,055 | 104,251,055 |
| Agency debentures | 1,250,506 | 1,250,506 | 889,580 | 889,580 |
| Investment in affiliates(2) | 203,057 | 203,057 | 211,970 | 211,970 |
| Receivable from Prime Broker | 3,272 | 3,272 | 3,272 | 3,272 |
| Equity securities(2) | - | - | 3,891 | 3,891 |
| Corporate debt(3) | 60,638 | 61,333 | 52,073 | 52,628 |
| Other derivatives(2) | 3,717 | 3,717 | 113 | 113 |
| Financial liabilities: | | | | |
| U.S. Treasury Securities sold, not yet purchased(2) | \$1,884,922 | \$1,884,922 | \$826,912 | \$826,912 |
| Repurchase agreements(1)(4) | 96,760,797 | 97,305,459 | 84,097,885 | 84,369,817 |
| Securities loaned(2) | 1,113,107 | 1,113,107 | 804,901 | 804,901 |
| Convertible Senior Notes(2) | 1,245,915 | 1,489,890 | 539,913 | 685,500 |
| Interest rate swaps | 2,822,264 | 2,822,264 | 2,552,687 | 2,552,687 |

(1) Carrying value approximates fair value due to the short-term maturities of these items.

(2) Fair value is determined using end of day quoted prices in active markets.

(3) The carrying value of the corporate debt is based on amortized cost. Estimates of fair value of corporate debt require the use of significant judgments and inputs including, but not limited to, the enterprise value of the borrower (i.e., an estimate of the total fair value of the borrower's debt and equity), the nature and realizable value of any collateral, the borrower's ability to make payments when due and its earnings history. Management also considers factors that affect the macro and local economic markets in which the borrower operates.

(4) The fair value of repurchase agreements with maturities greater than one year are valued as pay fixed versus receive floating interest rate swaps.

6. REPURCHASE AGREEMENTS

The Company had outstanding \$96.8 billion and \$84.1 billion of repurchase agreements with weighted average borrowing rates of 1.54% and 1.59%, after giving effect to the Company's interest rate swaps, and weighted average remaining maturities of 205 days and 103 days as of June 30, 2012 and December 31, 2011, respectively. Investment Securities and U.S. Treasury Securities pledged as collateral under these repurchase agreements and interest rate swaps had an estimated fair value and accrued interest of \$102.2 billion and \$372.6 million at June 30, 2012, respectively, and \$91.3 billion and \$337.0 million at December 31, 2011, respectively.

At June 30, 2012 and December 31, 2011, the repurchase agreements had the following remaining maturities and weighted average rates:

| | June 30, 2012 | | December 31, 2011 | | |
|------------------------|-----------------------|-----------------------|-----------------------|-----------------------|---|
| | Repurchase Agreements | Weighted Average Rate | Repurchase Agreements | Weighted Average Rate | |
| (dollars in thousands) | | | | | |
| 1 day | \$- | - | \$508,647 | 0.50 | % |
| 2 to 29 days | 32,549,648 | 0.40 | % 33,780,070 | 0.37 | % |
| 30 to 59 days | 22,134,932 | 0.40 | % 28,346,380 | 0.37 | % |
| 60 to 89 days | 5,302,260 | 0.55 | % 3,699,425 | 0.93 | % |
| 90 to 119 days | 11,125,373 | 0.37 | % 6,781,137 | 0.37 | % |
| Over 120 days | 25,648,584 | 1.10 | % 10,982,226 | 1.39 | % |
| Total | \$96,760,797 | 0.59 | % \$84,097,885 | 0.53 | % |

The Company did not have an amount at risk greater than 10% of the equity of the Company with any counterparty as of June 30, 2012 or December 31, 2011.

7. DERIVATIVE INSTRUMENTS

In connection with the Company's interest rate risk management strategy, the Company economically hedges a portion of its interest rate risk by entering into derivative financial instrument contracts. As of June 30, 2012, such instruments are comprised of interest rate swaps, which in effect modify the cash flows on repurchase agreements, or convert floating rate liabilities to fixed rates. The use of interest rate swaps creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. The purpose of the swaps is to mitigate the risk of rising interest rates that affect the Company's cost of funds. In the event of a default by the counterparty, the Company could have difficulty obtaining its Investment Securities pledged as collateral for swaps. The Company does not anticipate any defaults by its counterparties. The Company's interest rate swaps have not been designated as hedging instruments for accounting purposes.

The location and fair value of interest rate swaps reported in the Consolidated Statements of Financial Condition as of June 30, 2012 and December 31, 2011 are as follows:

| | Location on Consolidated Statements of Financial Condition | Notional Amount | Net Estimated Fair Value |
|-------------------|--|------------------------|--------------------------|
| | | (dollars in thousands) | |
| June 30, 2012 | Assets: Interest rate swaps, at fair value | - | - |
| June 30, 2012 | Liabilities: Interest rate swaps, at fair value | \$46,205,070 | \$(2,822,264) |
| December 31, 2011 | Assets: Interest rate swaps, at fair value | - | - |
| December 31, 2011 | Liabilities: Interest rate swaps, at fair value | \$40,109,880 | \$(2,552,687) |

The effect of interest rate swaps on the Consolidated Statements of Comprehensive Income is as follows:

| | Location on Consolidated Statements of Comprehensive Income | | |
|--|---|---|---------------------------------------|
| | Realized Gains (Losses) on Interest | Gain (loss) on Termination of Interest Rate | Unrealized Gains (Losses) on Interest |
| | | | |

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| | Rate Swaps* | Swaps | Rate Swaps |
|--|------------------------|------------|--------------|
| | (dollars in thousands) | | |
| For the Quarter Ended June 30, 2012 | \$(222,002) | - | \$(611,215) |
| For the Quarter Ended June 30, 2011 | \$(216,760) | - | \$(466,943) |
| For the Six Months Ended June 30, 2012 | \$(441,342) | \$(2,385) | \$(269,576) |
| For the Six Months Ended June 30, 2011 | \$(422,908) | - | \$(297,635) |

* Net interest payments on interest rate swaps is presented in the Company's Consolidated Statements of Comprehensive Income as realized gains (losses) on interest rate swaps.

The Company's interest rate swap weighted average pay rate at June 30, 2012 was 2.29% and the weighted average receive rate was 0.30%. The weighted average pay rate at June 30, 2011 was 2.79% and the weighted average receive rate was 0.21%. Without netting the market value of the swaps by dealer at June 30, 2012, the gross unrealized losses on interest rate swaps was \$2.8 billion, with a notional amount of \$46.0 billion and the gross unrealized gains on interest rate swaps was \$82,000 with a notional amount of \$250.0 million. Without netting the market value of the swaps by dealer at June 30, 2011, the gross unrealized loss on interest rate swaps was \$1.0 billion, with a notional amount of \$32.4 billion, and the gross unrealized gain on interest rate swaps was \$23.2 million, with a notional amount of \$3.2 billion.

Certain of the Company's derivative contracts are subject to International Swaps and Derivatives Association Master Agreements ("ISDA") which contain provisions that grant counterparties certain rights with respect to the applicable ISDA upon the occurrence of (i) negative performance that results in a decline in net assets in excess of specified thresholds or dollar amounts over set periods of time, (ii) the Company's failure to maintain its REIT status, (iii) the Company's failure to comply with limits on the amount of leverage, and (iv) the Company's stock being delisted from the New York Stock Exchange (NYSE). Upon the occurrence of items (i) through (iv), the counterparty to the applicable ISDA has a right to terminate the ISDA in accordance with its provisions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a net liability position at June 30, 2012 is approximately \$2.9 billion, including accrued interest, which represents the maximum amount the Company would be required to pay upon termination, which is fully collateralized.

In connection with RCap's proprietary trading activities, it has entered into exchange traded U.S. interest rate, equity index, and FX futures and options contracts as well as German interest rate futures contracts for speculative or hedging purposes. RCap invests in futures and options contracts for economic hedging purposes to reduce exposure to changes in yields of its U.S Treasury securities and for speculative purposes to achieve capital appreciation. The use of options contracts creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. RCap executes these trades through an independent futures and options broker.

8. CONVERTIBLE SENIOR NOTES

In 2010, the Company issued \$600.0 million in aggregate principal amount of its 4% convertible senior notes due 2015 ("4% Convertible Senior Notes") for net proceeds of approximately \$582.0 million. Interest on the 4% Convertible Senior Notes is paid semi-annually at a rate of 4% per year and the Convertible Senior Notes will mature on February 15, 2015 unless repurchased or converted earlier. The 4% Convertible Senior Notes are convertible into shares of Common Stock at a conversion rate for each \$1,000 principal amount of 4% Convertible Senior Notes. The initial conversion rate was 46.6070. The conversion rate at June 30, 2012 was 66.5527, which is equivalent to an initial conversion price and conversion price at June 30, 2012 of approximately \$21.4560 and \$15.0257 per share of Common Stock, respectively, subject to adjustment in certain circumstances. There is no limit on the total number of shares of Common Stock that the Company would be required to issue upon a conversion.

During the quarter ended June 30, 2012, the Company determined that the 4% Convertible Senior Notes included a contingent beneficial conversion feature. During the quarter ended June 30, 2011, the 4% Convertible Senior Notes were not considered to have a contingent beneficial conversion feature. The intrinsic value of the contingent beneficial conversion feature was \$92.9 million at June 30, 2012, which is reflected in Additional paid in capital on the Company's Consolidated Statements of Financial Condition, and serves to reduce the 4% Convertible Senior Notes liability. The \$92.9 million discount to the principal amount of the 4% Convertible Senior Notes is recognized in interest expense over the remaining life of the notes using the effective yield method.

In May 2012, the Company issued \$750.0 million in aggregate principal amount of its 5% convertible senior notes due 2015 ("5% Convertible Senior Notes") for net proceeds of approximately \$727.5 million. Interest on the 5% Convertible Senior Notes is paid semi-annually at a rate of 5% per year and the 5% Convertible Senior Notes will mature on May 15, 2015 unless repurchased or converted earlier. The 5% Convertible Senior Notes are convertible into shares of Common Stock at a conversion rate for each \$1,000 principal amount of 5% Convertible Senior Notes. The initial conversion rate and conversion rate at June 30, 2012 is 52.7969, which is equivalent to an initial conversion price of approximately \$18.94 per share of Common Stock, subject to adjustment in certain circumstances. Upon conversion, the Company will pay or deliver, as the case may be, cash, shares of Common Stock or a combination of cash and shares of Common Stock, at the Company's sole discretion. There is no limit on the total number of shares of Common Stock that the Company would be required to issue upon a conversion.

At issuance, the Company determined that the 5% Convertible Senior Notes included a beneficial conversion feature of \$11.7 million, which is reflected in Additional paid in capital on the Company's Consolidated Statements of Financial Condition, and serves to reduce the 5% Convertible Senior Notes liability. The \$11.7 million discount to the principal amount of the Convertible Senior Notes is recognized in interest expense over the remaining life of the notes using the effective yield method. At June 30, 2012, \$11.2 million of the discount had not been reflected in interest expense.

9. PREFERRED STOCK AND COMMON STOCK

(A) Common Stock

During the quarter and six months ended June 30, 2012, 268,000 and 394,000 options were exercised for an aggregate exercise price of \$3.5 million and \$5.4 million, respectively. During the quarter and six months ended June 30, 2011, 279,127 options and 462,470 options were exercised for an aggregate exercise price of \$3.7 million and \$6.1 million, respectively.

During the six months ended June 30, 2012, 1.3 million shares of Series B Preferred Stock were converted into 4.0 million shares of common stock, respectively. During the quarter and six months ended June 30, 2011, 1,000 shares and 3,000 shares of Series B Preferred Stock were converted into 2,732 shares and 8,045 shares of common stock, respectively.

During the quarter and six months ended June 30, 2012, the Company raised \$845,000 through the Direct Purchase and Dividend Reinvestment Program. During the quarter and six months ended June 30, 2011, the Company raised \$454.6 million and \$455.7 million by issuing 26,090,380 shares and 26,154,175 shares through the Direct Purchase and Dividend Reinvestment Program, respectively.

On March 19, 2012, the Company entered into six separate Distribution Agency Agreements (or Distribution Agency Agreements) with each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., J.P. Morgan Securities LLC, Morgan Stanley & Co. LLC and RCap Securities, Inc. (together, the "Agents"). Pursuant to the terms of the Distribution Agency Agreements, the Company may sell from time to time through the Agents, as its sales agents, up to 125,000,000 shares of the Company's common stock. The Company did not make any sales under the Distribution Agency Agreements during the quarter ended June 30, 2012.

On January 4, 2011, the Company entered into an agreement pursuant to which it sold 86,250,000 shares of its common stock for net proceeds of approximately \$1.5 billion. This transaction settled on January 7, 2011.

On February 15, 2011, the Company entered into an agreement pursuant to which it sold 86,250,000 shares of its common stock for net proceeds of approximately \$1.5 billion. This transaction settled on February 18, 2011.

On July 11, 2011 the Company entered into an agreement pursuant to which it sold 138,000,000 shares of its common stock for net proceeds following expenses of approximately \$2.4 billion. This transaction settled on July 15, 2011.

On June 23, 2011, the Company amended its charter to increase the number of authorized shares of capital stock, par value \$0.01 per share, from 1,000,000,000 shares to 2,000,000,000 shares, consisting of 1,987,987,500 shares classified as Common Stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, and 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock.

On May 16, 2012, the Company amended its charter through the filing of articles supplementary to its charter to reclassify 12,650,000 shares of authorized shares of Common Stock as 7.625% Series C Cumulative Redeemable Preferred Stock. Following the effectiveness of the articles supplementary to its charter the Company's authorized shares of capital stock, par value of \$0.01 per share, consists of 1,975,337,500 shares classified as Common Stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock, and 12,650,000 shares classified as 7.625% Series C Cumulative Redeemable Preferred Stock.

(B) Preferred Stock

At June 30, 2012 and December 31, 2011, the Company had issued and outstanding 7,412,500 shares of Series A Cumulative Redeemable Preferred Stock ("Series A Preferred Stock"), with a par value of \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series A 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 A Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on April 5, 2009 (subject to the Company's right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve its qualification as a REIT). The Series A Preferred Stock is senior to the Company's common stock and is on parity with the Series C Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series A Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series A Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series A Preferred Stock, together with the Series C 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 restricted for payment. In addition, certain material and adverse changes to the terms of the Series A Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series A Preferred Stock and Series C Preferred Stock. Through June 30, 2012, the Company had declared and paid all required quarterly dividends on the Series A Preferred Stock.

In May 2012, the Company issued 12,000,000 shares of Series C Cumulative Redeemable Preferred Stock ("Series C Preferred Stock"), with a par value of \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series C Preferred Stock is entitled to a dividend at a rate of 7.625% per year based on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series C Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on May 16, 2017 (subject to the Company's right under limited circumstances to redeem the Series C Preferred Stock earlier in order to preserve its qualification as a REIT or under limited circumstances related to a change of control of the Company). The Series C Preferred Stock is senior to the Company's common stock and is on parity with the Series A Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series C Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series C Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series C Preferred Stock, together with 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 restricted for payment. In addition, certain material and adverse changes to the terms of the Series C Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series C Preferred Stock and Series A Preferred Stock. Through June 30, 2012, the Company had declared and paid all required quarterly dividends on the Series C Preferred Stock.

At December 31, 2011, the Company had issued and outstanding 1,331,849 shares of Series B Preferred Stock, with a par value \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). On March 27, 2012, the Company announced that it elected to convert all outstanding shares of Series B Preferred Stock into shares of common stock. In this conversion, the Company converted 772,000 shares of Series B Preferred Stock into 2.4 million shares of common stock and the Company had no shares of Series B Preferred Stock outstanding at June 30, 2012.

The Series B Preferred Stock was paid a dividend at a rate of 6% per year on the \$25.00 liquidation preference before the common stock received any dividends. The Series B Preferred Stock was not redeemable. The Series B Preferred Stock was convertible into shares of common stock at a conversion rate that adjusted from time to time upon the occurrence of certain events, including when the Company distributed to its common shareholders in any calendar quarter cash dividends in excess of \$0.11 per share. Initially, the conversion rate was 1.7730 shares of common shares per \$25 liquidation preference, and the Series B Preferred Stock was converted into common stock at a conversion ratio of 3.0614 shares of common stock for each share of Series B Preferred Stock. The Series B Preferred Stock was also convertible into common shares at the option of the Series B preferred shareholder anytime at the then prevailing conversion rate. The Series B Preferred Stock was senior to the Company's common stock and on parity with the Series A Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series B Preferred Stock generally did not have any voting rights, except if the Company failed to pay dividends on the Series B Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series B Preferred Stock, together with the Series A Preferred Stock, would be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and restricted for payment. In addition, certain material and adverse changes to the terms of the Series B Preferred Stock could not be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series B Preferred Stock and Series A Preferred Stock. Through March 31, 2012, the Company had declared and paid all required quarterly dividends on the Series B Preferred Stock. During the six months ended June 30, 2012, 1.3 million shares of Series B Preferred Stock were converted into 4.0 million shares of common stock. During the quarter and six months ended June 30, 2011, 1,000 and 3,000 shares of Series B Preferred Stock were converted into 2,732 and 8,045 shares of common stock, respectively.

(C)

Distributions to Shareholders

During the quarter and six months ended June 30, 2012, the Company declared dividends to common shareholders totaling \$535.9 million or \$0.55 per share, and \$1.1 billion or \$1.10 per share, respectively, which \$535.9 million was paid to shareholders on July 26, 2012. During the quarter and six months ended June 30, 2012, the Company declared dividends to Series A Preferred shareholders totaling approximately \$3.6 million or \$0.492 per share and \$7.3 million or \$0.984 per share, respectively. During the quarter and six months ended June 30, 2012, the Company declared dividends to Series B shareholders totaling approximately \$0 or \$0 per share and \$289,000 or \$0.375 per share, respectively. During the quarter and six months ended June 30, 2012, the Company declared dividends to Series C shareholders totaling approximately \$2.9 million or \$0.238 per share.

During the quarter and six months ended June 30, 2011, the Company declared dividends to common shareholders totaling \$540.0 million or \$0.65 per share and \$1.0 billion or \$1.27 per share, respectively, of which \$540.0 million was paid to shareholders on July 28, 2011. During the quarter and six months ended June 30, 2011, the Company declared dividends to Series A Preferred shareholders totaling approximately \$3.6 million or \$0.4922 per share and \$7.3 million or \$0.9844 per share, and Series B shareholders totaling approximately \$618 thousand or \$0.375 per share and approximately \$1.2 million or \$0.750 per share, respectively.

10. NET INCOME PER COMMON SHARE

The following table presents a reconciliation of the net income and shares used in calculating basic and diluted earnings per share for the quarters and six months ended June 30, 2012 and 2011.

| For the Quarter Ended | | For the Six Months Ended | |
|------------------------|----------|--------------------------|----------|
| June 30, | June 30, | June 30, | June 30, |
| 2012 | 2011 | 2012 | 2011 |
| (dollars in thousands) | | | |

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| | | | | |
|--|-------------|------------|------------|------------|
| Net income (loss) | \$(91,159) | \$ 120,817 | \$ 810,647 | \$ 820,712 |
| Less: Preferred stock dividends | 6,508 | 4,267 | 10,446 | 8,534 |
| Net income (loss) available to common shareholders, prior to adjustment for dilutive potential common shares, if necessary | (97,667) | \$ 116,550 | 800,201 | \$ 812,178 |
| Add: Preferred Series B dividends, if dilutive | - | 618 | - | 1,237 |
| Add: Interest on Convertible Senior Notes, if dilutive | - | - | 16,896 | 12,000 |
| Net income (loss) available to common shareholders, as adjusted | \$(97,667) | \$ 117,168 | \$ 817,097 | \$ 825,415 |
| Weighted average shares of common stock outstanding-basic | 974,555 | 822,623 | 973,142 | 787,713 |
| Add: Effect of dilutive stock options, Series B Cumulative Convertible Preferred Stock and Convertible Senior Notes, if dilutive | - | 5,132 | 79,746 | 39,909 |
| Weighted average shares of common stock outstanding-diluted | 974,555 | 827,755 | 1,052,888 | 827,622 |

Options to purchase 5.8 million and 2.8 million shares of common stock were outstanding and considered anti-dilutive for the quarter and six months ended June 30, 2012. Options to purchase 572,000 shares of common stock were outstanding and considered anti-dilutive as their exercise price exceeded the average stock price for the quarter and six months ended June 30, 2011.

11. LONG-TERM STOCK INCENTIVE PLANS

The Company has adopted the 2010 Equity Incentive Plan, which authorizes the Compensation Committee of the board of directors to grant options, stock appreciation rights, dividend equivalent rights, or other share-based awards, including restricted shares up to an aggregate of 25,000,000 shares, subject to adjustments as provided in the 2010 Equity Incentive Plan. The Company had adopted a long term stock incentive plan for executive officers, key employees and non-employee directors (the Prior Plan). The Prior Plan authorized the Compensation Committee of the board of directors to grant awards, including non-qualified options as well as incentive stock options as defined under Section 422 of the Code. The Prior Plan authorized the granting of options or other awards for an aggregate of the greater of 500,000 shares or 9.5% of the diluted outstanding shares of the Company's common stock, up to a ceiling of 8,932,921 shares. No further awards will be made under the Prior Plan, although existing awards remain effective.

Stock options were issued at the market price on the date of grant, subject to an immediate or four year vesting in four equal installments with a contractual term of 5 or 10 years.

The Company has issued and outstanding the following stock options as of June 30, 2012 and 2011:

| | For the Six Months Ended | | | |
|--|--------------------------|---------------------------------------|---------------------|---------------------------------------|
| | June 30, 2012 | | June 30, 2011 | |
| | Number of Shares | Weighted Average Exercise Price | Number of Shares | Weighted Average Exercise Price |
| Options outstanding at the beginning of period | 6,216,805 | \$ 15.57 | 6,891,975 | \$ 15.20 |
| Granted | 7,500 | 17.11 | 7,500 | 18.67 |
| Exercised | (394,019) | 13.68 | (462,470) | 13.22 |
| Forfeited | - | - | - | - |
| Expired | - | - | (3,750) | 12.15 |
| Options outstanding at the end of period | 5,830,286 | \$ 15.68 | 6,433,255 | \$ 15.49 |
| Options exercisable at the end of the period | 4,943,055 | \$ 15.99 | 4,411,630 | \$ 16.06 |

The weighted average remaining contractual term was approximately 4.9 years for stock options outstanding and approximately 4.5 years for stock options exercisable as of June 30, 2012. As of June 30, 2012, there was approximately \$2.1 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 1 year.

The weighted average remaining contractual term was approximately 6.0 years for stock options outstanding and approximately 5.3 years for stock options exercisable as of June 30, 2011. As of June 30, 2011, there was approximately \$6.4 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 1.6 years.

12. INCOME TAXES

For the quarter and six months ended June 30, 2012 the Company is qualified to be taxed as a REIT. As a REIT, the Company is not subject to federal income tax to the extent that it distributes its taxable income to its shareholders. To maintain qualification as a REIT, the Company must distribute at least 90% of its annual REIT taxable income to its shareholders and meet certain other requirements. It is generally the Company's policy to distribute to its shareholders all of the Company's taxable income except for the amount of taxable income attributable to certain employee remuneration deductions disallowed for tax purposes pursuant to Internal Revenue Code Section 162(m).

Accordingly, in general, the Company is subject to federal, state and local income taxes on taxable income attributable to the Section 162(m) disallowance. It is assumed that the Company intends to retain its REIT status by complying with the REIT regulations and its distribution policy in the future. The state and city tax jurisdictions for which the Company is subject to tax filing obligations recognized the Company's status as a REIT.

During the quarter and six months ended June 30, 2012, the Company recorded \$7.4 million and \$22.1 million of income tax expense for the portion of earnings retained based on Section 162(m) limitations. During the quarter and six months ended June 30, 2011, the Company recorded \$10.1 million and \$19.5 million of income tax expense for the portion of earnings retained based on Section 162(m) limitations.

The Company's effective tax rate differs from its combined federal, state, and city corporate statutory tax rate primarily due to the deduction of dividend distributions and Section 162(m) limitations.

During the quarter and six months ended June 30, 2012, the Company's taxable REIT subsidiaries recorded \$4.3 million and \$6.0 million of income tax expense. During the quarter and six months ended June 30, 2011, the Company's taxable REIT subsidiaries recorded \$2.7 million and \$6.8 million of income tax expense.

The Company's 2008, 2009 and 2010 federal and state tax returns remain open for examination.

13. LEASE COMMITMENTS AND CONTINGENCIES

Commitments

The Company has a non-cancelable lease for office space which commenced in May 2002 and expires in December 2015. Merganser has a non-cancelable lease for office space, which commenced on May 2003 and expires in May 2014. Merganser subleases a portion of its leased space to a subtenant. FIDAC has a lease for office space which commenced in October 2010 and expires in February 2016. The Company's aggregate net future minimum lease payments total approximately \$7.1 million. The following table details the lease payments.

| Year Ending December | Lease | | Net Amount |
|----------------------|------------|---|------------|
| | Commitment | Sublease Income (dollars in thousands) | |
| 2012 (remaining) | \$ 1,501 | \$ 90 | \$ 1,411 |
| 2013 | 3,004 | 60 | 2,944 |
| 2014 | 2,520 | - | 2,520 |
| 2015 | 159 | - | 159 |
| 2016 | 27 | - | 27 |
| Thereafter | - | - | - |
| | \$ 7,211 | \$ 150 | \$ 7,061 |

Contingencies

From time to time, the Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Company's consolidated financial statements and therefore no accrual is required as of June 30, 2012 and December 31, 2011.

14. INTEREST RATE RISK

The primary market risk to the Company 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 the Company's control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with the interest-bearing 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 the Company's interest earning assets and the Company's ability to realize gains from the sale of these assets. A decline in the value of the interest earning assets 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.

The Company seeks to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. The Company may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in the portfolio of interest earning assets by entering into interest rate agreements such as interest rate caps and interest rate swaps. As of June 30, 2012 and December 31, 2011, the Company entered into interest rate swaps to pay a fixed rate and receive a floating rate of interest, with a total notional amount of \$46.2 billion and \$40.1 billion, respectively.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Agency mortgage-backed securities. The Company will seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets purchased at a premium with assets purchased at a discount. To date, the aggregate premium exceeds the aggregate discount on the Agency mortgage-backed securities. As a result, prepayments, which result in the amortization of unamortized premium, will reduce net income compared to what net income would be absent such prepayments.

15. RCAP REGULATORY REQUIREMENTS

RCap is subject to regulations of the securities business that include but are not limited to trade practices, use and safekeeping of funds and securities, capital structure, recordkeeping, and conduct of directors, officers and employees.

As a self clearing, registered broker dealer, RCap is subject to the minimum net capital requirements of the FINRA. As of June 30, 2012 RCap had a minimum net capital requirement of \$340,268 and would be required to notify FINRA if capital was to fall below the early warning threshold of \$408,322. RCap consistently operates with capital significantly in excess of its regulatory capital requirements. RCap's regulatory net capital as defined by SEC Rule 15c3-1 as of June 30, 2012 was \$348.7 million with excess net capital of \$348.4 million.

16. RELATED PARTY TRANSACTIONS

For the quarter and six months ended June 30, 2012, the Company recorded advisory fees from affiliates totaling \$17.4 million and \$33.9 million, respectively. For the quarter and six months ended June 30, 2011, the Company recorded advisory fees from affiliates totaling \$16.5 million and \$30.0 million, respectively. At June 30, 2012 and 2011, the Company had amounts receivable from affiliates of \$17.4 million and \$16.6 million, respectively.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

Certain statements contained in this quarterly report, and certain statements contained in our future filings with the Securities and Exchange Commission (the SEC or the Commission"), in our press releases or in our other public or shareholder communications may not be based on historical facts and are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements, which are based on various assumptions, (some of which are beyond our control) may be identified by reference to a future period or periods, or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue," or similar terms or variations on those terms, or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors, including, but not limited to, changes in interest rates, changes in the yield curve, changes in prepayment rates, the availability of mortgage-backed securities and other securities for purchase, the availability of financing, and, if available, the terms of any financings, changes in the market value of our assets, changes in business conditions and the general economy, our ability to consummate any contemplated investment opportunities, changes in governmental regulations affecting our business, our ability to maintain our classification as a REIT for federal income tax purposes, our ability to maintain our exemption from registration under the Investment Company Act of 1940, and risks associated with the business of our subsidiaries, including the investment advisory businesses of our subsidiaries, including the removal by their clients of assets they manage, their regulatory requirements, and competition in the investment advisory business, and risks associated with the broker dealer business of our subsidiary. For a discussion of the risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements, see our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q. We do not undertake and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

All references to “we,” “us,” or “our” mean Annaly Capital Management, Inc. and all entities owned by us, except where it is made clear that the term means only the parent company. The following defines certain of the commonly used terms in this quarterly report on Form 10-Q: Agency refers to a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae; Agency mortgage-backed securities refers to residential mortgage-backed securities that are issued or guaranteed by an Agency; Investment Securities refers to Agency mortgage-backed securities, Agency debentures, corporate debt securities and reverse repurchase agreement loans; and Interest Earning Assets refers to Investment Securities, securities borrowed and U.S. Treasury Securities.

Overview

We own, manage, and finance a portfolio of real estate related investments, including mortgage pass-through certificates, collateralized mortgage obligations (or CMOs), Agency callable debentures, and other securities representing interests in or obligations backed by pools of mortgage loans. Our principal business objective is to generate net income for distribution to our stockholders from the spread between the interest income on our Interest-Earning Assets and the costs of borrowing to finance our acquisition of Interest-Earning Assets and from dividends we receive from our subsidiaries. Our wholly-owned subsidiaries offer diversified real estate, asset management and other financial services.

We are a Maryland corporation that commenced operations on February 18, 1997. We are self-advised and self-managed. We acquired Fixed Income Discount Advisory Company (or FIDAC) on June 4, 2004 and Merganser Capital Management, Inc. (or Merganser) on October 31, 2008. FIDAC and Merganser manage a number of investment vehicles and separate accounts for which they earn fee income. Our subsidiary, RCap Securities, Inc. (or RCap), operates as a broker-dealer, and was granted membership in the Financial Industry Regulatory Authority (or FINRA) in January 2009. In 2010, we established Shannon Funding LLC (or Shannon), which provides warehouse financing to residential mortgage originators in the United States. In 2010, we also established Charlesfort Capital Management LLC (or Charlesfort), which engages in corporate middle market lending transactions. In 2011, FIDAC established FIDAC Europe Limited (or FIDAC Europe), which provides advice on commercial real estate transactions, including sale-leaseback and single tenant net leased properties across Europe. In 2011, we established FIDAC FSI LLC (or FIDAC FSI), which invests in trading securities. We also own an additional subsidiary which owns trading securities.

We have elected and believe that we are organized and have operated in a manner that qualifies us to be taxed as a real estate investment trust (or REIT) under the Internal Revenue Code of 1986, as amended (or the Code). If we qualify for taxation as a REIT, we generally will not be subject to federal income tax on our taxable income that is distributed to our stockholders. Therefore, substantially all of our assets, other than FIDAC, Merganser and RCap, which are our taxable REIT subsidiaries, consist of qualified REIT real estate assets (of the type described in Section 856(c)(5)(B) of the Code). We have financed our purchases of Agency mortgage-backed securities and Agency debentures with the net proceeds of equity offerings, convertible notes offerings and borrowings under repurchase agreements whose interest rates adjust based on changes in short-term market interest rates.

Capital Investment Policy

Under our capital investment policy, at least 75% of our total assets must be comprised of high-quality mortgage-backed securities and short-term investments. High quality securities means securities that (1) are rated within one of the two highest rating categories by at least one of the nationally recognized rating agencies, (2) are unrated but are guaranteed by the United States government or an agency of the United States government, or (3) are unrated but we determine them to be of comparable quality to high-quality rated mortgage-backed securities.

The remainder of our assets, comprising not more than 25% of our total assets, may consist of other qualified REIT real estate assets which are unrated or rated less than high quality, but which are at least “investment grade” (rated “BBB” or better by Standard & Poor’s Corporation (or S&P) or the equivalent by another nationally recognized rating agency) or, if not rated, we determine them to be of comparable credit quality to an investment which is rated “BBB” or better. In addition, we may directly or indirectly invest part of this remaining 25% of our assets in other types of securities, including without limitation, unrated debt, equity or derivative securities, to the extent consistent with our REIT qualification requirements. The derivative securities in which we invest may include securities representing the right to receive interest only or a disproportionately large amount of interest, as well as inverse floaters, which may have imbedded leverage as part of their structural characteristics.

We may acquire Agency mortgage-backed securities backed by single-family residential mortgage loans as well as securities backed by loans on multi-family, commercial or other real estate related properties. To date, substantially all of the Agency mortgage-backed securities that we have acquired have been backed by single-family residential mortgage loans.

The results of our operations are affected by various factors, many of which are beyond our control. Our results of operations primarily depend on, among other things, our net interest income, the market value of our assets and the supply of and demand for such assets. Our net interest income, which reflects the amortization of purchase premiums and accretion of discounts, 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 speeds, as reflected by the Constant Prepayment Rate, or CPR, and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds on our Agency mortgage-backed securities portfolio increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. The CPR on our Agency mortgage-backed securities portfolio averaged 19% and 22% for the quarters ended June 30, 2012 and December 31, 2011, respectively. Since changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT. We continue to explore alternative business strategies, alternative investments and other strategic initiatives to complement our core business strategy of investing, on a leveraged basis, in high quality Investment Securities. No assurance, however, can be provided that any such strategic initiative will or will not be implemented in the future.

The table below provides quarterly information regarding our average interest-earning assets, interest income, yield on average interest-earning assets, average interest-bearing liabilities, economic interest expense, average cost of interest-bearing liabilities, economic net interest income, and net interest rate spreads for the periods presented.

| | Average Interest- Earning Assets(1) | Total Interest Income | Yield on Average Interest- Earning Assets | Average Interest- Bearing Liabilities | Average Interest Expense (2) | Average Cost of Interest- Bearing Liabilities | Economic Net Interest Income(3) | Net Interest Rate Spread |
|---------------------------------------|--|-----------------------------|--|--|---------------------------------------|---|--|-----------------------------------|
| Quarter Ended June 30, 2012 | \$ 116,458,864 | \$ 886,324 | 3.04 % | \$ 103,668,465 | \$ 388,445 | 1.50 % | \$ 497,879 | 1.54 % |
| Quarter Ended March 31, 2012 | \$ 105,706,554 | \$ 854,895 | 3.23 % | \$ 92,552,175 | \$ 352,685 | 1.52 % | \$ 502,210 | 1.71 % |
| Year Ended December 31, 2011 | \$ 96,675,016 | \$ 3,579,618 | 3.70 % | \$ 84,595,933 | \$ 1,362,721 | 1.61 % | \$ 2,216,897 | 2.09 % |
| Quarter Ended December | \$ 102,339,797 | \$ 847,700 | 3.31 % | \$ 89,488,111 | \$ 357,771 | 1.60 % | \$ 489,929 | 1.71 % |

(ratios for the quarters have been annualized, dollars in thousands)

| | | | | | | | | | | | |
|---|---------------|-----------|------|---|--------------|-----------|------|---|-----------|------|---|
| 31, 2011 Quarter Ended September 30, 2011 | \$100,473,505 | \$930,802 | 3.71 | % | \$86,617,908 | \$353,266 | 1.63 | % | \$577,536 | 2.08 | % |
| Quarter Ended June 30, 2011 | \$94,696,473 | \$957,068 | 4.04 | % | \$83,042,390 | \$330,080 | 1.59 | % | \$626,988 | 2.45 | % |
| Quarter Ended March 31, 2011 | \$89,190,290 | \$844,048 | 3.79 | % | \$79,235,324 | \$321,604 | 1.62 | % | \$522,444 | 2.17 | % |

(1) Does not reflect unrealized gains/ (losses) or premium/ (discount).

(2) Economic interest expense includes interest expense on interest rate swaps.

(3) Economic net interest income includes interest expense on interest rate swaps.

Our net interest rate spread has declined since the quarter ended June 30, 2011. The declining net interest rate spread is primarily attributable to the continuing low interest rate environment and marginally higher CPR, which as discussed above, reduces the net yield on our Agency mortgage-backed securities portfolio.

The following table presents the CPR experienced on our Agency mortgage-backed securities portfolio, on an annualized basis, for the quarterly periods presented.

| Quarter Ended | CPR |
|--------------------|-----|
| June 30, 2012 | 19% |
| March 31, 2012 | 19% |
| December 31, 2011 | 22% |
| September 30, 2011 | 18% |
| June 30, 2011 | 11% |

For the purpose of calculating average interest-earning assets and interest-bearing liabilities, daily balances are used. For the purposes of computing ratios relating to equity measures throughout this report, equity includes Series B preferred stock, which has been treated under GAAP as temporary equity. For the purpose of computing net interest income and ratios relating to cost of funds measures throughout this report, interest expense includes interest expense on interest rate swaps, which is classified in the Consolidated Statements of Comprehensive Income as Realized gains (losses) on interest rate swaps. Interest rate swaps are used to hedge the increase in interest expense on repurchase agreements in a rising rate environment. Presenting the contractual interest payments on interest rate swaps with the interest expense on interest-bearing liabilities reflects total contractual interest payments. This presentation depicts the economic value of our investment strategy. Interest expense, including interest payments on interest rate swaps, is referred to as economic interest expense. Net interest income, including interest payments on interest rate swaps, is referred to as economic net interest income.

The following table compares the GAAP and non-GAAP measurements reflected in the Management's Discussion and Analysis of Financial Condition and Results of Operations. Non-GAAP measurements include non-GAAP total stockholders' equity, economic interest expense and economic net interest income.

| | GAAP Total Stockholders' Equity | Non-GAAP Total Stockholders' Equity | GAAP Interest Expense (dollars in thousands) | Economic Interest Expense | GAAP Net Interest Income | Economic Net interest Income |
|--|---------------------------------------|--|---|---------------------------------|--------------------------------|------------------------------------|
| For the Quarter Ended June 30, 2012 | \$ 16,284,586 | \$ 16,284,586 | \$ 166,443 | \$ 388,445 | \$ 719,881 | \$ 497,879 |
| For the Quarter Ended March 31, 2012 | \$ 15,940,605 | \$ 15,940,605 | \$ 133,345 | \$ 352,685 | \$ 721,550 | \$ 502,210 |
| For the Year Ended December 31, 2011 | \$ 15,760,642 | \$ 15,792,914 | \$ 480,326 | \$ 1,362,721 | \$ 3,099,292 | \$ 2,216,897 |
| For the Quarter Ended December 31, 2011 | \$ 15,760,642 | \$ 15,792,914 | \$ 130,133 | \$ 357,771 | \$ 717,567 | \$ 489,929 |
| For the Quarter Ended September 30, 2011 | \$ 15,910,022 | \$ 15,943,686 | \$ 121,417 | \$ 353,266 | \$ 809,385 | \$ 577,536 |
| For the Quarter Ended June 30, 2011 | \$ 13,929,362 | \$ 13,969,321 | \$ 113,320 | \$ 330,080 | \$ 843,748 | \$ 626,988 |
| For the Quarter Ended March 31, 2011 | \$ 12,853,017 | \$ 12,893,000 | \$ 115,456 | \$ 321,604 | \$ 728,592 | \$ 522,444 |

We believe that the non-GAAP total stockholders' equity, economic interest expense and economic net interest income provides meaningful information to consider, in addition to the respective amounts prepared in accordance with GAAP. The non-GAAP measures help us to evaluate our financial position and performance without the effects of certain transactions and GAAP adjustments that are not necessarily indicative of our current investment portfolio, operations, capitalization, or shareholders' equity.

Exposure to European financial counterparties

A significant portion of our Agency mortgage-backed securities are financed with repurchase agreements. We secure our borrowings under these agreements by pledging our Agency mortgage-backed securities as collateral to the lender. The collateral we pledge exceeds the amount of the borrowings under each agreement, typically with the extent of over-collateralization being at least 3% of the amount borrowed. If the counterparty to the repurchase agreement defaults on its obligations and we are not able to recover our pledged assets, we are at risk of losing the over-collateralized amount. The amount of this exposure is the difference between the amount loaned to us plus interest due to the counterparty and the fair value of the collateral pledged by us to the lender including accrued interest receivable on such collateral.

We also use interest rate swaps to manage our interest rate risks. Under these swap agreements, we pledge Agency mortgage-backed securities as collateral as part of a margin arrangement for interest rate swaps that are in an unrealized loss position. If a counterparty were to default on its obligation, we would be exposed to a loss to a swap counterparty to the extent that the amount of our Agency mortgage-backed securities pledged exceeded the unrealized loss on the associated swaps and we were not able to recover the excess collateral.

Over the past several years, several large European financial institutions have experienced financial difficulty and have been either rescued by government assistance or by other large European banks or institutions. Some of these financial institutions or their U.S. subsidiaries have provided us financing under repurchase agreements or we have entered into interest rate swaps with such institutions. We have entered into repurchase agreements and/or interest rate swaps with 12 financial institution counterparties that are either domiciled in Europe or a U.S. based subsidiary of a European domiciled financial institution. The following table summarizes our exposure to such counterparties at June 30, 2012:

| Country (dollars in thousands) | Number of Counterparties | Repurchase Agreement Financing | Interest Rate Swaps at Fair Value | Exposure(1) | Exposure as a Percentage of Total Assets | |
|-----------------------------------|--------------------------------|--------------------------------------|---|--------------|---|---|
| France | 4 | \$ 3,828,369 | \$ (211,662) | \$ 259,533 | 0.20 | % |
| Germany | 1 | \$ 3,172,837 | \$ (440,636) | \$ 264,772 | 0.21 | % |
| Netherlands | 2 | \$ 5,129,996 | \$ (34,970) | \$ 298,148 | 0.23 | % |
| Scotland | 1 | \$ 863,919 | - | \$ 53,648 | 0.04 | % |
| Switzerland | 2 | \$ 6,107,714 | \$ (446,836) | \$ 458,604 | 0.36 | % |
| England | 2 | \$ 8,372,857 | \$ (133,034) | \$ 439,913 | 0.34 | % |
| Total | 12 | \$ 27,475,692 | \$ (1,267,138) | \$ 1,774,618 | 1.38 | % |

(1) Represents the amount of cash and/or securities pledged as collateral to each counterparty less the aggregate of repurchase agreement financing and unrelated loss on swaps for each counterparty..

At June 30, 2012, we did not use credit default swaps or other forms of credit protection to hedge the exposures summarized in the table above.

If the European credit crisis continues to impact these major European financial institutions, it is possible that it will also impact the operations of their U.S. subsidiaries. Our financings and operations could be adversely affected by such events. We monitor our exposure to our repurchase agreement and swap counterparties on a regular basis, using various methods, including review of recent rating agency actions, financial relief plans, credit spreads or other developments and by monitoring the amount of cash and securities collateral pledged and the associated loan amount under repurchase agreements and/or the fair value of swaps with our counterparties. We make reverse margin calls on our counterparties to recover excess collateral as permitted by the agreements governing our financing arrangements or interest rate swaps, or may try to take other actions to reduce the amount of our exposure to a counterparty when necessary.

Results of Operations:

Net Income Summary

For the quarter ended June 30, 2012, our net loss was \$91.2 million or \$0.10 basic loss per average share related to common shareholders, as compared to \$120.8 million net income or \$0.14 basic income per average share for the quarter ended June 30, 2011. Net income decreased \$212.0 million for the quarter ended June 30, 2012, when compared to the quarter ended June 30, 2011. We attribute the majority of the decrease in net income for the quarter ended June 30, 2012 from the quarter ended June 30, 2011 to unrealized loss on interest rate swaps and interest only Agency mortgage backed securities of \$637.3 million for the quarter ended June 30, 2012, as compared to unrealized

losses on interest rate swaps and interest only Agency mortgage backed securities of \$466.7 million for the quarter ended June 30, 2011.

For the six months ended June 30, 2012, our net income was \$810.6 million, or \$0.82 basic income per average share related to common shareholders, as compared to \$820.7 million net income or \$1.03 basic net income per average share for the six months ended June 30, 2011. We attribute the decrease in net income for the six months ended June 30, 2012 from the six months ended June 30, 2011 to the decline in economic net interest income of \$149.3 million and the increase in total expenses of \$23.4 million. The decline in economic net interest income and increase in total expenses were only partially offset by the increase in realized net gains on sales of Agency mortgage-backed securities and debentures of \$140.6 million.

The table below presents the net income summary for the quarters and six months ended June 30, 2012 and 2011.

| Net Income Summary | | | | |
|---|------------------------|---------------|--------------------------|---------------|
| (dollars in thousands, except for per share data) | | | | |
| | For the Quarters Ended | | For the Six Months Ended | |
| | June 30, 2012 | June 30, 2011 | June 30, 2012 | June 30, 2011 |
| Interest income: | | | | |
| Investments | \$ 876,229 | \$ 948,703 | \$ 1,727,188 | \$ 1,786,583 |
| U.S. Treasury Securities | 7,397 | 6,497 | 8,815 | 11,322 |
| Securities loaned | 2,698 | 1,868 | 5,216 | 3,211 |
| Total interest income | 886,324 | 957,068 | 1,741,219 | 1,801,116 |
| Interest expense: | | | | |
| Repurchase agreements | 139,579 | 100,164 | 253,493 | 202,766 |
| Convertible Senior Notes | 18,965 | 6,900 | 33,692 | 13,667 |
| U.S. Treasury Securities sold, not yet purchased | 5,801 | 4,772 | 8,445 | 9,758 |
| Securities borrowed | 2,098 | 1,484 | 4,158 | 2,585 |
| Total interest expense | 166,443 | 113,320 | 299,788 | 228,776 |
| Net interest income | 719,881 | 843,748 | 1,441,431 | 1,572,340 |
| Other income (loss): | | | | |
| Investment advisory and other fee income | 21,929 | 20,710 | 42,695 | 37,917 |
| Net gains (losses) on sales of Agency mortgage-backed securities and debentures | 94,837 | 7,336 | 175,136 | 34,521 |
| Dividend income from affiliates | 6,621 | 8,230 | 14,142 | 14,527 |
| Net gains (losses) on trading assets | 1,105 | (5,712) | 6,361 | 13,100 |
| Net unrealized gain (losses) on interest-only Agency mortgage-backed securities | (26,103) | 276 | 4,774 | 276 |
| Income (expense) from underwriting | (8) | (77) | (16) | 2,827 |
| Subtotal | 98,381 | 30,763 | 243,092 | 103,168 |
| Realized gains (losses) on interest rate swaps(1) | (222,002) | (216,760) | (441,342) | (422,908) |
| Realized gain (loss) on termination of interest rate swaps | - | - | (2,385) | - |
| Unrealized gains (losses) on interest rate swaps | (611,215) | (466,943) | (269,576) | (297,635) |
| Subtotal | (833,217) | (683,703) | (713,303) | (720,543) |
| Total other income (loss) | (734,836) | (652,940) | (470,211) | (617,375) |
| Expenses: | | | | |

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| | | | | |
|---|----------------|---------------|----------------|---------------|
| Compensation expense | 53,536 | 49,752 | 112,500 | 94,282 |
| Other general and administrative expenses | 11,012 | 7,477 | 19,905 | 14,774 |
| Total expenses | 64,548 | 57,229 | 132,455 | 109,056 |
| Income (loss) before income taxes and income from equity method investment in affiliate | | | | |
| | (79,503) | 133,579 | 838,765 | 845,909 |
| Income taxes | (11,656) | (12,762) | (28,118) | (26,337) |
| Income from equity method investment in affiliate | - | - | - | 1,140 |
| Net income (loss) | (91,159) | 120,817 | 810,647 | 820,712 |
| Dividends on preferred stock | 6,508 | 4,267 | 10,446 | 8,534 |
| Net income (loss) available (related) to common shareholders | \$ (97,667) | \$ 116,550 | \$ 800,201 | \$ 812,178 |
| Net income (loss) available (related) per share to common shareholders: | | | | |
| Basic | \$ (0.10) | \$ 0.14 | \$ 0.82 | \$ 1.03 |
| Diluted | \$ (0.10) | \$ 0.14 | \$ 0.78 | \$ 1.00 |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 974,555,392 | 822,623,370 | 973,141,546 | 787,712,527 |
| Diluted | 974,555,392 | 827,754,731 | 1,052,888,301 | 827,622,301 |
| Average total assets | \$ 124,293,056 | \$ 99,492,308 | \$ 119,405,371 | \$ 94,003,737 |
| Average equity | \$ 16,112,596 | \$ 13,431,161 | \$ 16,006,035 | \$ 12,255,751 |
| Return on average total assets | (0.29 %) | 0.49 % | 1.36 % | 1.75 % |
| Return on average equity | (2.26 %) | 3.60 % | 10.13 % | 13.39 % |

(1) Interest expense related to the Company's interest rate swaps is recorded in Realized gains (losses) on interest rate swaps on the Consolidated Statements of Comprehensive Income.

Interest Income and Average Earning Asset Yield

Our interest income for the quarters ended June 30, 2012 and 2011 was \$886.3 million and \$957.1 million, respectively. We had average interest earning assets of \$116.5 billion and \$94.7 billion for the quarters ended June 30, 2012 and 2011, respectively. While our average interest earning assets increased period-over-period by \$21.8 billion, the yield on our average interest earning assets decreased from 4.04% for the quarter ended June 30, 2011 to 3.04% for the quarter ended June 30, 2012. Additionally, the prepayment speeds increased to an average of 19% CPR for the quarter ended June 30, 2012 from an average of 11% for the quarter ended June 30, 2011.

Our interest income for the six months ended June 30, 2012 and 2011 was \$1.7 billion and \$1.8 billion, respectively. We had average interest earning assets of \$111.1 billion and \$91.9 billion for the quarters ended June 30, 2012 and 2011, respectively. While our average interest earning assets increased period-over-period by \$19.2 billion, the yield on our average interest earning assets decreased from 3.92% for the six months ended June 30, 2011 to 3.13% for the six months ended June 30, 2012. Additionally, the prepayment speeds increased to an average of 19% CPR for the six months ended June 30, 2012 from an average of 14% for the six months ended June 30, 2011.

Economic Interest Expense and the Cost of Interest-Bearing Liabilities

Our largest expense is the cost of interest-bearing liabilities. We had average interest-bearing liabilities of \$103.7 billion and total economic interest expense of \$388.4 million, which includes \$222.0 million in interest paid on interest rate swaps, for the quarter ended June 30, 2012. We had average interest-bearing liabilities of \$83.0 billion and total economic interest expense of \$330.1 million, which includes \$216.8 million in interest paid on interest rate swaps, for the quarter ended June 30, 2011. Our average cost of interest-bearing liabilities was 1.50%, including interest paid on interest rate swaps, for the quarter ended June 30, 2012 and 1.59% for the quarter ended June 30, 2011. The cost of interest-bearing liabilities rate decreased by 9 basis points and the average interest-bearing liabilities increased by \$20.7 billion for the quarter ended June 30, 2012, when compared to the quarter ended June 30, 2011. Economic interest expense, including interest paid on interest rate swaps, for the quarter ended June 30, 2012 increased by \$58.3 million when compared to the quarter ended June 30, 2011, due to the increase in interest-bearing liabilities.

We had average interest-bearing liabilities of \$98.1 billion and total economic interest expense of \$741.1 million, which includes \$441.3 million in interest paid on interest rate swaps, for the six months ended June 30, 2012. We had average interest-bearing liabilities of \$81.1 billion and total economic interest expense of \$651.7 million, which includes \$422.9 million in interest paid on interest rate swaps, for the six months ended June 30, 2011. Our average cost of interest-bearing liabilities was 1.51%, including interest paid on interest rate swaps, for the six months ended June 30, 2012 and 1.61% for the six months ended June 30, 2011. The cost of interest-bearing liabilities rate decreased by 10 basis points and the average interest-bearing liabilities increased by \$17.0 billion for the six months ended June 30, 2012, when compared to the six months ended June 30, 2011. Economic interest expense, including interest paid on interest rate swaps, for the six months ended June 30, 2012 increased by \$89.4 million when compared to the six months ended June 30, 2011, due to the increase in interest-bearing liabilities.

The table below shows our average interest-bearing liabilities and average cost of interest-bearing liabilities as compared to average one-month and average six-month LIBOR for the periods presented.

Average Cost of Interest-Bearing Liabilities
(Quarterly ratios have been annualized, dollars in thousands)

| | Average Interest-Bearing Liabilities | Interest-Bearing Liabilities at Period End | Economic Interest Expense(1) | Average Cost of Interest-Bearing Liabilities | Average One-Month LIBOR | Average Six-Month LIBOR | Average One-Month LIBOR Relative to Average Six-Month LIBOR | Average Cost of Interest-Bearing Liabilities Relative to Average One-Month LIBOR | Average Cost of Interest-Bearing Liabilities Relative to Average Six-Month LIBOR |
|--|--------------------------------------|--|------------------------------|--|-------------------------|-------------------------|---|--|--|
| For the Quarter Ended June 30, 2012 | \$103,668,465 | \$101,004,741 | \$388,445 | 1.50 % | 0.24 % | 0.73 % | (0.49 %) | 1.26 % | 0.77 % |
| For the Quarter Ended March 31, 2012 | \$92,552,175 | \$95,700,039 | \$352,685 | 1.52 % | 0.26 % | 0.76 % | (0.50 %) | 1.26 % | 0.76 % |
| For the Year Ended December 31, 2011 | \$84,595,933 | \$86,269,611 | \$1,362,721 | 1.61 % | 0.23 % | 0.51 % | (0.28 %) | 1.38 % | 1.10 % |
| For the Quarter Ended December 31, 2011 | \$89,488,111 | \$86,269,611 | \$357,771 | 1.60 % | 0.26 % | 0.68 % | (0.42 %) | 1.34 % | 0.92 % |
| For the Quarter Ended September 30, 2011 | \$86,671,908 | \$88,509,516 | \$353,266 | 1.63 % | 0.21 % | 0.47 % | (0.26 %) | 1.42 % | 1.16 % |
| For the Quarter Ended June 30, 2011 | \$83,042,390 | \$79,986,235 | \$330,080 | 1.59 % | 0.20 % | 0.42 % | (0.22 %) | 1.39 % | 1.17 % |
| For the Quarter Ended | \$79,235,324 | \$81,732,664 | \$321,604 | 1.62 % | 0.26 % | 0.46 % | (0.20 %) | 1.36 % | 1.16 % |

March 31,
2011

(1) Economic interest expense includes interest expense on interest rate swaps.

We do not manage our portfolio to have a pre-designated amount of borrowings at quarter or year end. Our borrowings at period end are a snapshot of borrowings as of a date, and this number should be expected to differ from average borrowings over the period for a number of reasons. The mortgage-backed securities we own pay principal and interest towards the end of each month and the mortgage-backed securities we purchase are typically settled during the beginning of the month. As a result, depending on the amount of mortgage-backed securities we have committed to purchase, we may retain the principal and interest we receive in the prior month, or we may use it to pay down our borrowings. Moreover, we use interest rate swaps to hedge our portfolio and as we pledge or receive collateral under these agreements, our borrowings on any given day may be increased or decreased. Our average borrowings during a quarter will differ from period end borrowings as we implement our portfolio management strategies and risk management strategies over changing market conditions by increasing or decreasing leverage. Additionally, these numbers will differ during periods when we conduct capital raises, as in certain instances we may purchase additional assets and increase leverage with the expectation of a successful capital raise. Since our average borrowings and period end borrowings can be expected to differ, we believe our average borrowings during a period provides a more accurate representation of our exposure to the risks associated with leverage.

Economic Net Interest Income

Our economic net interest income, including interest paid on interest rate swaps, decreased by \$129.1 million for the quarter ended June 30, 2012, as compared to the quarter ended June 30, 2011, because of the decline in interest rate spread. Our net interest rate spread for the quarter ended June 30, 2012 was 1.54%, which was 91 basis points less than the interest rate spread for the quarter ended June 30, 2011 of 2.45%. This 91 basis point decrease in interest rate spread for second quarter of 2012 compared to the spread for second quarter of 2011 was the result of the decrease in average yield on average interest earning assets of 100 basis points partially offset by a decrease in the average cost of interest-bearing liabilities of 9 basis points. The estimated weighted average yield on our investment portfolio at June 30, 2012 was 3.17% and estimated cost of funds on interest-bearing liabilities was 1.58%, resulting in an estimated interest rate spread of 1.59%.

Our economic net interest income, including interest paid on interest rate swaps, decreased by \$149.3 million for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011, because of the decline in interest rate spread. Our net interest rate spread for the six months ended June 30, 2012 was 1.62%, which was 69 basis points less than the interest rate spread for the six months ended June 30, 2011 of 2.31%.

The net interest rate spread continued to decline every quarter over the past year. This trend could continue in the current environment as a result of declining coupons and increased acquisition prices. The weighted average coupon at June 30, 2012 declined to 4.30%, when compared to the weighted average coupon at June 30, 2011 of 4.67%. Additionally, the weighted average purchase price increased to 103.2% at June 30, 2012 from 102.1% at June 30, 2011. The decline in interest rate spread may continue to decline, if there is a decline in yield on investments acquired, an increase in prepayment speed, or increased funding cost.

The table below shows our economic net interest income by average interest earning assets held, total interest income, yield on average interest earning assets, average interest-bearing liabilities, economic interest expense, average cost of interest-bearing liabilities, economic net interest income, and net interest rate spread for the periods presented.

Economic Net Interest Income
(Quarterly ratios have been annualized, dollars in thousands)

| | Average Interest Earning Assets | Total Interest Income | Yield on Average Interest Earning Assets | Average Interest- Bearing Liabilities | Economic Interest Expense(1) | Average Cost of Interest-Bearing Liabilities | Economic Net Interest Income (1) | Net Interest Rate Spread |
|--|--|-----------------------------|---|--|------------------------------------|---|---|-----------------------------------|
| For the Quarter Ended June 30, 2012 | \$ 116,458,864 | \$ 886,324 | 3.04 % | \$ 103,668,465 | \$ 388,445 | 1.50 % | \$ 497,879 | 1.54 % |
| For the Quarter Ended March 31, 2012 | \$ 105,706,554 | \$ 854,895 | 3.23 % | \$ 92,552,175 | \$ 352,685 | 1.52 % | \$ 502,210 | 1.71 % |
| For the Year Ended December 31, 2011 | \$ 96,675,016 | \$ 3,579,618 | 3.70 % | \$ 84,595,933 | \$ 1,362,721 | 1.61 % | \$ 2,216,897 | 2.09 % |
| For the Quarter Ended December 31, 2011 | \$ 102,339,797 | \$ 847,700 | 3.31 % | \$ 89,488,111 | \$ 357,771 | 1.60 % | \$ 489,929 | 1.71 % |
| For the Quarter Ended September 30, 2011 | \$ 100,473,505 | \$ 930,802 | 3.71 % | \$ 86,671,908 | \$ 353,266 | 1.63 % | \$ 577,536 | 2.08 % |

| | | | | | | | | |
|--|---------------|------------|--------|---------------|------------|--------|------------|--------|
| For the Quarter Ended June 30, 2011 | \$ 94,696,473 | \$ 957,068 | 4.04 % | \$ 83,042,390 | \$ 330,080 | 1.59 % | \$ 626,988 | 2.45 % |
| For the Quarter Ended March 31, 2011 | \$ 89,190,290 | \$ 844,048 | 3.79 % | \$ 79,235,324 | \$ 321,604 | 1.62 % | \$ 522,444 | 2.17 % |

(1) Economic interest expense and economic net interest income include interest expense on interest rate swaps.

Investment Advisory and Other Fee Income

FIDAC and Merganser are registered investment advisors specializing in managing fixed income securities. Net investment advisory and fees for the quarters ended June 30, 2012 and 2011 totaled \$21.9 million and \$20.7 million, respectively, net of fees paid to third parties pursuant to distribution service agreements for facilitating and promoting distribution of shares or units to FIDAC's and Merganser's clients. Net investment advisory and fees for the six months ended June 30, 2012 and 2011 totaled \$42.7 million and \$37.9 million, respectively, net of fees paid to third parties pursuant to distribution service agreements for facilitating and promoting distribution of shares or units to FIDAC's and Merganser's clients.

Gains and Losses on Sales of Agency Mortgage-Backed Securities and Agency Debentures

For the quarter ended June 30, 2012, we disposed of Agency mortgage-backed securities and Agency debentures with a carrying value of \$6.4 billion for an aggregate net gain of \$94.8 million. For the quarter ended June 30, 2011 we disposed of Agency mortgage-backed securities and Agency debentures with a carrying value of \$1.7 billion for an aggregate net gain of \$7.3 million. We do not expect to sell assets on a frequent basis, but may from time to time sell existing assets to acquire new assets, which our management believes might have higher risk-adjusted returns, or to manage our balance sheet as part of our asset/liability management strategy.

For the six months ended June 30, 2012, we disposed of Agency mortgage-backed securities and Agency debentures with a carrying value of \$11.7 billion for an aggregate net gain of \$175.1 million. For the six months ended June 30, 2011 we disposed of Agency mortgage-backed securities and Agency debentures with a carrying value of \$5.6 billion for an aggregate net gain of \$34.5 million.

Dividend Income from Available-For-Sale Equity Securities

Dividend income from our investments in Chimera Investment Corporation and CreXus Investment Corp., which are managed pursuant to management contracts by our wholly owned subsidiary FIDAC, totaled \$6.6 million and \$14.1 million for the quarter and six months ended June 30, 2012, as compared to \$8.2 million and \$14.5 million for the quarter and six months ended June 30, 2011.

General and Administrative Expenses

General and administrative (or G&A) expenses were \$64.5 million and \$132.5 million for the quarter and six months ended June 30, 2012 respectively, compared to \$57.2 million and \$109.1 million for the quarter and six months ended June 30, 2011, respectively. G&A expenses as a percentage of average total assets was 0.21% and 0.23% for the quarters ended June 30, 2012 and 2011, respectively. The increase in G&A expenses of \$7.3 million for the quarter ended June 30, 2012 as compared to June 30, 2011 was primarily the result of increased compensation costs related to us and our subsidiaries, as staff increased from 136 as of June 30, 2011 to 152 as of June 30, 2012.

The table below shows our total G&A expenses as compared to average total assets and average equity for the periods presented.

G&A Expenses and Operating Expense Ratios
(ratios for the quarters have been annualized, dollars in thousands)

| | Total G&A Expenses | Total G&A Expenses/Average Assets | | Total G&A Expenses/Average Equity | |
|--|-----------------------|---|---|---|---|
| For the Quarter Ended June 30, 2012 | \$ 64,548 | 0.21 | % | 1.60 | % |
| For the Quarter Ended March 31, 2012 | \$ 67,907 | 0.24 | % | 1.71 | % |
| For the Year Ended December 31, 2011 | \$ 237,344 | 0.23 | % | 1.73 | % |
| For the Quarter Ended December 31, 2011 | \$ 63,094 | 0.23 | % | 1.59 | % |
| For the Quarter Ended September 30, 2011 | \$ 65,194 | 0.24 | % | 1.74 | % |
| For the Quarter Ended June 30, 2011 | \$ 57,229 | 0.23 | % | 1.70 | % |
| For the Quarter Ended March 31, 2011 | \$ 51,827 | 0.23 | % | 1.82 | % |

Net Income and Return on Average Equity

Our net loss was \$91.2 million for the quarter ended June 30, 2012 and our net income was \$120.8 million for the quarter ended June 30, 2011. Our annualized loss on average equity was 2.26% for the quarter ended June 30, 2012, and our annualized return on average equity was 3.60% for the quarter ended June 30, 2011. Net income decreased by \$212.0 million for the quarter ended June 30, 2012 as compared to the quarter ended June 30, 2011, primarily due to the increase in unrealized losses on interest rate swaps and interest only agency mortgage backed securities of \$170.7 million.

Our net income was \$810.6 million for the six months ended June 30, 2012 and \$820.7 million for the six months ended June 30, 2011. Our annualized return on average equity was 10.13% for the six months ended June 30, 2012,

and 13.39% for the six months ended June 30, 2011. Net income decreased by \$10.1 million for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011, primarily due to a decrease in economic net interest income of \$149.3 million, which was partially offset by an increase in net gains on sales of Agency mortgage-backed securities and debentures of \$140.6 million.

The table below shows the components of our return on average equity for the periods presented.

Components of Return on Average Equity

(Ratios for the quarters have been annualized)

| | Economic Net Interest Income/ Average Equity(1) | Net Investment Advisory and Service Fees/Average Equity | Realized and Unrealized Gains and Losses/Average Equity | Dividend Income from available-for- sale equity securities/ Average Equity | Income from Under- writing /Average Equity | Income from Equity Method Investment /Average Equity | G&A Expenses/ Average Equity |
|--|---|---|---|--|---|--|---------------------------------------|
| For the Quarter Ended June 30, 2012 | 12.37 | % 0.54 | % (13.44 | %) 0.16 | % 0.00 | % 0.00 | % (1.60 |
| For the Quarter Ended March 31, 2012 | 12.66 | % 0.52 | % 11.49 | % 0.19 | % 0.00 | % 0.00 | % (1.71 |
| For the Year Ended December 31, 2011 | 16.18 | % 0.58 | % (12.36 | %) 0.23 | % 0.04 | % 0.00 | % (1.73 |
| For the Quarter Ended December 31, 2011 | 12.35 | % 0.52 | % 0.18 | % 0.21 | % 0.00 | % 0.00 | % (1.59 |
| For the Quarter Ended September 30, 2011 | 15.45 | % 0.56 | % (38.81 | %) 0.23 | % 0.07 | % 0.00 | % (1.74 |
| For the Quarter Ended June 30, 2011 | 18.67 | % 0.62 | % (13.86 | %) 0.25 | % 0.00 | % 0.00 | % (1.70 |
| For the Quarter Ended March 31, 2011 | 18.33 | % 0.60 | % 7.56 | % 0.23 | % 0.10 | % 0.04 | % (1.82 |

- (1) Economic net interest income includes interest expense on interest rate swaps.

Financial Condition

Investment Securities

Substantially all of our Agency mortgage-backed securities at June 30, 2012 and December 31, 2011 were mortgage-backed securities backed by single-family mortgage loans. Substantially all of the mortgage assets underlying our Agency mortgage-backed securities were secured with a first lien position on the underlying single-family properties. Substantially all of our mortgage-backed securities were Freddie Mac, Fannie Mae or Ginnie Mae pass through certificates or CMOs, which carry an actual or implied "AAA" rating. We carry all of our Agency mortgage-backed securities at fair value.

We accrete discount balances as an increase in interest income over the expected life of the related interest earning assets and we amortize premium balances as a decrease in interest income over the expected life of the related interest earning assets. At June 30, 2012 and December 31, 2011 we had on our Consolidated Statements of Financial Condition a total of \$33.2 million and \$27.3 million, respectively, of unaccreted discount (which is the difference between the remaining principal value and current historical amortized cost of our Investment Securities acquired at a price below principal value) and a total of \$4.5 billion and \$3.4 billion, respectively, of unamortized premium (which is the difference between the remaining principal value and the current historical amortized cost of our Investment Securities acquired at a price above principal value).

We received mortgage principal repayments of \$7.9 billion and \$3.8 billion for the quarters ended June 30, 2012 and 2011, respectively. The average prepayment speed for the quarters ended June 30, 2012 and 2011 was 19% and 11%, respectively. Given our current portfolio composition, if mortgage principal prepayment rates were to increase over the life of our mortgage-backed securities, all other factors being equal, our net interest income would decrease during the life of these mortgage-backed securities as we would be required to amortize our net premium balance into income over a shorter time period. Similarly, if mortgage principal prepayment rates were to decrease over the life of our mortgage-backed securities, all other factors being equal, our net interest income would increase during the life of these mortgage-backed securities as we would amortize our net premium balance over a longer time period.

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The table below summarizes certain characteristics of our Agency mortgage-backed securities, Agency debentures and corporate debt as of the dates presented.

Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt
(dollars in thousands)

| | Principal Amount | Net Premium | Amortized Cost | Amortized Cost/Principal Amount | Carrying Value | Carrying Value/Principal Amount | Weighted Average Yield |
|-----------------------|------------------|--------------|----------------|---------------------------------|----------------|---------------------------------|------------------------|
| At June 30, 2012 | \$ 111,975,194 | \$ 4,463,950 | \$ 116,439,144 | 103.99 % | \$ 119,811,793 | 107.00 % | 3.17 % |
| At March 31, 2012 | \$ 105,296,991 | \$ 3,815,555 | \$ 109,112,546 | 103.62 % | \$ 111,841,645 | 106.22 % | 3.21 % |
| At December 31, 2011 | \$ 98,904,501 | \$ 3,333,416 | \$ 102,237,917 | 103.37 % | \$ 105,192,708 | 106.35 % | 3.22 % |
| At September 30, 2011 | \$ 100,957,108 | \$ 3,394,180 | \$ 104,351,288 | 103.36 % | \$ 107,440,790 | 106.42 % | 3.58 % |
| At June 30, 2011 | \$ 92,465,377 | \$ 2,986,266 | \$ 95,451,643 | 103.23 % | \$ 97,504,523 | 105.45 % | 3.73 % |
| At March 31, 2011 | \$ 90,209,946 | \$ 2,900,102 | \$ 93,110,048 | 103.21 % | \$ 94,080,293 | 104.29 % | 3.96 % |

The tables below summarize certain characteristics of our Agency mortgage-backed securities, Agency debentures and corporate debt as of the dates presented. The index level for adjustable-rate Agency mortgage-backed securities, Agency debentures and corporate debt is the weighted average rate of the various short-term interest rate indices, which determine the coupon rate.

Adjustable-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt
Characteristics
(dollars in thousands)

| | Principal Amount | Weighted Average Coupon Rate | Weighted Average Term to Next Adjustment | Weighted Average Lifetime Cap | Weighted Average Asset Yield | Principal Amount at Period End as % of Total Investment Securities |
|-----------------------|------------------|------------------------------|--|-------------------------------|------------------------------|--|
| At June 30, 2012 | \$ 8,648,932 | 3.67 % | 38 months | 9.42 % | 2.80 % | 7.72 % |
| At March 31, 2012 | \$ 9,104,082 | 3.72 % | 38 months | 8.80 % | 2.78 % | 8.65 % |
| At December 31, 2011 | \$ 9,268,113 | 3.88 % | 41 months | 9.64 % | 2.79 % | 9.37 % |
| At September 30, 2011 | \$ 9,917,372 | 3.85 % | 40 months | 9.63 % | 2.79 % | 9.82 % |
| At June 30, 2011 | \$ 10,000,985 | 4.12 % | 42 months | 10.08 % | 3.22 % | 10.82 % |
| At March 31, 2011 | \$ 10,623,084 | 4.21 % | 39 months | 10.09 % | 3.02 % | 11.78 % |

Fixed-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt Characteristics
(dollars in thousands)

| Principal Amount | Weighted Average | Weighted Average | Principal Amount at Period |
|------------------|------------------|------------------|----------------------------|
|------------------|------------------|------------------|----------------------------|

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| | | | Coupon Rate | | Asset Yield | | End as % of Total Investment Securities | |
|-----------------------|----|-------------|-------------|---|-------------|---|--|---|
| At June 30, 2012 | \$ | 103,326,262 | 4.52 | % | 3.20 | % | 92.28 | % |
| At March 31, 2012 | \$ | 96,192,909 | 4.63 | % | 3.25 | % | 91.35 | % |
| At December 31, 2011 | \$ | 89,636,388 | 4.71 | % | 3.07 | % | 90.63 | % |
| At September 30, 2011 | \$ | 91,039,736 | 4.81 | % | 3.78 | % | 90.18 | % |
| At June 30, 2011 | \$ | 82,464,392 | 4.74 | % | 3.83 | % | 89.18 | % |
| At March 31, 2011 | \$ | 79,586,862 | 4.80 | % | 4.19 | % | 88.22 | % |

At June 30, 2012 and December 31, 2011, we held Agency mortgage-backed securities, Agency debentures and corporate debt with coupons linked to various indices. The following tables detail the portfolio characteristics by index.

Adjustable-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt by Index
June 30, 2012

| | One- Month Libor | Six- Month Libor | Twelve Month Libor | 12-Month Moving Average | 11th District Cost of Funds | 1-Year Treasury Index | Other Indices(1) |
|---|------------------------|------------------------|--------------------------|-------------------------------|--------------------------------------|-----------------------------|---------------------|
| Weighted Average Term to Next Adjustment | 1 mo. | 6 mo. | 48 mo. | 1 mo. | 4 mo. | 28 mo. | 31 mo. |
| Weighted Average Annual Period Cap | 5.82 % | 1.66 % | 2.00 % | 0.02 % | 0.18 % | 1.92 % | 0.01 % |
| Weighted Average Lifetime Cap at June 30, 2012 | 5.85 % | 11.13 % | 9.83 % | 9.45 % | 10.67 % | 11.18 % | 6.71 % |
| Investment Principal Value as Percentage of Investment Securities at June 30, 2012 | 0.22 % | 0.35 % | 5.19 % | 0.27 % | 0.24 % | 0.39 % | 1.06 % |

(1) Combination of indices that account for less than 0.05% of total or adjust over time, without a reset index.

Adjustable-Rate Agency Mortgage-Backed Securities, Agency Debentures and Corporate Debt by Index
December 31, 2011

| | One- Month Libor | Six- Month Libor | Twelve Month Libor | 12-Month Moving Average | 11th District Cost of Funds | 1-Year Treasury Index | Other Indices(1) |
|---|------------------------|------------------------|--------------------------|-------------------------------|--------------------------------------|-----------------------------|---------------------|
| Weighted Average Term to Next Adjustment | 1 mo. | 7 mo. | 52 mo. | 4 mo. | 4 mo. | 31 mo. | 31 mo. |
| Weighted Average Annual Period Cap | 6.25 % | 1.63 % | 2.00 % | 0.03 % | 0.20 % | 1.88 % | 0.61 % |
| Weighted Average Lifetime Cap at December 31, 2011 | 6.84 % | 11.10 % | 9.93 % | 9.46 % | 10.66 % | 10.35 % | 6.87 % |
| Investment Principal Value as Percentage of Investment Securities at December 31, 2011 | 0.39 % | 0.44 % | 6.55 % | 0.35 % | 0.30 % | 0.57 % | 0.77 % |

(1) Combination of indices that account for less than 0.05% of total or adjust over time, without a reset index.

Borrowings

As of June 30, 2012 and December 31, 2011, 96% and 97%, respectively, of our debt consisted of borrowings collateralized by a pledge of our Investment Securities. These borrowings appear on our Consolidated Statement of Financial Condition as repurchase agreements. All of our Agency mortgage-backed securities and debentures are currently accepted as collateral for these borrowings. However, we limit our borrowings, and thus our potential asset growth, in order to maintain unused borrowing capacity and thus increase the liquidity and strength of our balance sheet. As of June 30, 2012 the term to maturity of our borrowings ranged from two days to 7 years. As of December 31, 2011 the term to maturity of our borrowings ranged from one day to 7 years. Additionally, we have entered into

structured borrowings giving the counterparty the right to call the balance prior to maturity. As of June 30, 2012 and December 31, 2011, the weighted average cost of funds for all of our borrowings was 1.58% and 1.60%, respectively, including the effect of the interest rate swaps and 4% convertible senior notes due 2015 and 5% convertible senior notes due 2015 (collectively, the "Convertible Senior Notes"), and the weighted average maturity was 216 days and 110 days, respectively.

Liquidity

Liquidity, which is our ability to turn non-cash assets into cash, allows us to purchase additional interest earning assets and to pledge additional assets to secure existing borrowings should the value of our pledged assets decline. Potential immediate sources of liquidity for us include cash balances and unused borrowing capacity. Our non-cash assets are largely actual or implied AAA assets, and accordingly, we have not had, nor do we anticipate having, difficulty in converting our assets to cash. Our balance sheet also generates liquidity on an on-going basis through mortgage principal repayments and net earnings held prior to payment as dividends. Should our needs ever exceed these on-going sources of liquidity plus the immediate sources of liquidity discussed above, we believe that in most circumstances our interest earning assets could be sold to raise cash. The maintenance of liquidity is one of the goals of our capital investment policy. Under this policy, we limit asset growth in order to preserve unused borrowing capacity for liquidity management purposes.

We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will use the collateral immediately for borrowing under a new repurchase agreement. We have not at the present time entered into any commitment agreements under which the lender would be required to enter into new repurchase agreements during a specified period of time, nor do we presently plan to have liquidity facilities with commercial banks.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a margin call), which may take the form of additional securities or cash. Similarly, if the estimated fair value of interest earning assets increases due to changes in market interest rates or market factors, lenders may release collateral back to us. Specifically, margin calls result from a decline in the value of our Agency mortgage-backed securities securing our repurchase agreements, prepayments on the mortgages securing such Agency mortgage-backed securities and to changes in the estimated fair value of such Agency mortgage-backed securities generally due to principal reduction of such Agency mortgage-backed securities from scheduled amortization and resulting from changes in market interest rates and other market factors. Our repurchase agreements generally provide that the valuations for the Agency mortgage-backed securities securing our repurchase agreements are to be obtained from a generally recognized source agreed to by the parties. However, in certain circumstances and under certain of our repurchase agreements our lenders have the sole discretion to determine the value of the Agency mortgage-backed securities securing our repurchase agreements. In instances where we have agreed to permit our lenders to make a determination of the value of the Agency mortgage-backed securities securing our repurchase agreements, such lenders are required to act in good faith in making such valuation determinations and in certain of these instances are also required to act reasonably in this determination. Our repurchase agreements generally provide that in the event of a margin call we must provide additional securities or cash on the same business day that a margin call is made, if the lender provides us notice prior to the margin notice deadline on such day. Through June 30, 2012, we did not have any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should prepayment speeds on the mortgages underlying our Agency mortgage-backed securities and/or market interest rates suddenly increase, margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

At June 30, 2012, we had total pledged collateral for repurchase agreements and interest rate swaps of \$102.2 billion. The weighted average haircut was approximately 5% on repurchase agreements. The excess collateral cushion totaled approximately \$5.4 billion. The quality and character of the Agency mortgage-backed securities that we pledge as collateral under the repurchase agreements and interest rate swaps did not materially change in the quarter and six months ended June 30, 2012 compared to quarter and six months ended June 30, 2011 and our counterparties did not materially alter any requirements, including required haircuts, related to the collateral we pledge under repurchase agreements and interest rate swaps during the quarter and six months ended June 30, 2012.

The following table summarizes the effect on our liquidity and cash flows from contractual obligations for repurchase agreements, interest expense on repurchase agreements and Convertible Senior Notes, the non-cancelable office lease and employment agreements as of June 30, 2012. The table does not include the effect of net interest rate payments under our interest rate swap agreements. The net swap payments will fluctuate based on monthly changes in the receive rate. As of June 30, 2012, the interest rate swaps had a net negative fair value of \$2.8 billion.

| | Contractual Obligations (dollars in thousands) | | | | |
|---|---|--------------------------|------------------------|-------------------------|--------------|
| | Within One Year | One to Three Years | Three to Five Years | More than Five Years | Total |
| Repurchase agreements | \$85,930,598 | \$3,365,199 | \$6,340,000 | \$1,125,000 | \$96,760,797 |
| Interest expense on repurchase agreements, based on rates at June 30, 2012 | 287,777 | 381,460 | 233,888 | 8,057 | 911,182 |
| Convertible Senior Notes | - | 1,350,000 | - | - | 1,350,000 |
| | 61,500 | 109,313 | - | - | 170,813 |

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Interest Expense on Convertible Senior

Notes

| | | | | | |
|---------------------------------------|--------------|-------------|-------------|-------------|--------------|
| Long-term operating lease obligations | 2,603 | 4,339 | 119 | - | 7,061 |
| Employment contracts | 144,711 | 221 | - | - | 144,932 |
| Total | \$86,427,189 | \$5,210,532 | \$6,574,007 | \$1,133,057 | \$99,344,785 |

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In the coming periods, we expect to continue to finance our activities in a manner that is consistent with our current operations via repurchase agreements. During the quarter and six months ended June 30, 2012, we received \$7.9 billion and \$15.3 billion from principal repayments, and used leverage on our Agency mortgage-backed securities which provided \$5.0 billion and \$12.7 billion in cash for the quarter and six months ended June 30, 2012. In addition, we may from time to time sell securities as a source of cash to fund new purchases. During the quarter and six months ended June 30, 2011, we received \$3.8 billion and \$9.4 billion from principal repayments, respectively, and used leverage on our Agency mortgage-backed securities which provided \$2.5 billion and \$12.2 billion in cash for the quarter and six months ended June 30, 2011, respectively.

Stockholders' Equity

During the quarter and six months ended June 30, 2012, 268,000 and 394,000 options were exercised for an aggregate exercise price of \$3.5 million and \$5.4 million, respectively. During the quarter and six months ended June 30, 2011, 279,127 options and 462,470 options were exercised for an aggregate exercise price of \$3.7 million and \$6.1 million, respectively.

During the six months ended June 30, 2012, 1.3 million shares of Series B Preferred Stock were converted into 4.0 million shares of common stock, respectively. During the quarter and six months ended June 30, 2011, 1,000 shares and 3,000 shares of Series B Preferred Stock were converted into 2,732 shares and 8,045 shares of common stock, respectively.

During the quarter and six months ended June 30, 2012, we raised \$845,000 through the Direct Purchase and Dividend Reinvestment Program. During the quarter and six months ended June 30, 2011, we raised \$454.6 million and \$455.7 million by issuing 26,090,380 shares and 26,154,175 shares through the Direct Purchase and Dividend Reinvestment Program, respectively.

On March 19, 2012, we entered into six separate Distribution Agency Agreements (or Distribution Agency Agreements) with each of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., J.P. Morgan Securities LLC, Morgan Stanley & Co. LLC and RCap Securities, Inc. (together, the Agents). Pursuant to the terms of the Distribution Agency Agreements, we may sell from time to time through the Agents, as our sales agents, up to 125,000,000 shares of our common stock. We did not make any sales under the Distribution Agency Agreements during the quarter ended June 30, 2012.

On January 4, 2011, we entered into an agreement pursuant to which we sold 86,250,000 shares of our common stock for net proceeds following expenses of approximately \$1.5 billion. This transaction settled on January 7, 2011.

On February 15, 2011, we entered into an agreement pursuant to which we sold 86,250,000 shares of our common stock for net proceeds following expenses of approximately \$1.5 billion. This transaction settled on February 18, 2011.

On July 11, 2011 we entered into an agreement pursuant to which we sold 138,000,000 shares of its common stock for net proceeds following expenses of approximately \$2.4 billion. This transaction settled on July 15, 2011.

On June 23, 2011, we amended our charter to increase the number of authorized shares of capital stock, par value \$0.01 per share, from 1,000,000,000 shares to 2,000,000,000 shares, consisting of 1,987,987,500 shares classified as Common Stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, and 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock.

On May 16, 2012, we amended our charter through the filing of articles supplementary to our charter to reclassify 12,650,000 shares of authorized shares of Common Stock as 7.625% Series C Cumulative Redeemable Preferred Stock. Following the effectiveness of the articles supplementary our authorized shares of capital stock, par value \$0.01 per share, consists of 1,975,337,500 shares classified as Common Stock, 7,412,500 shares classified as 7.875% Series A Cumulative Redeemable Preferred Stock, 4,600,000 shares classified as 6.00% Series B Cumulative Convertible Preferred Stock, and 12,650,000 shares classified as 7.625% Series C Cumulative Redeemable Preferred Stock.

Unrealized Gains and Losses

With our “available-for-sale” accounting treatment, unrealized fluctuations in market values of assets do not impact our GAAP or taxable income but rather are reflected on our balance sheet by changing the carrying value of the asset and stockholders’ equity under “Accumulated Other Comprehensive Income (Loss).” As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful

The table below shows unrealized gains and losses reflected in the Consolidated Statement of Comprehensive Income.

| | Unrealized Gains and Losses (dollars in thousands) | | | | |
|---------------------|---|-------------------|----------------------|-----------------------|---------------|
| | June 30, 2012 | March 31, 2012 | December 31, 2011 | September 30, 2011 | June 30, 2011 |
| Unrealized gain | \$ 3,497,635 | \$ 2,892,493 | \$ 3,091,152 | \$ 3,292,450 | \$ 2,378,880 |
| Unrealized loss | (84,315) | (126,063) | (82,164) | (218,962) | (329,049) |
| Net Unrealized gain | \$ 3,413,320 | \$ 2,766,430 | \$ 3,008,988 | \$ 3,073,488 | \$ 2,049,831 |

Unrealized changes in the estimated net fair value of available-for-sale investments have a direct effect on our potential earnings and dividends: positive changes increase our equity base and allow us to increase our borrowing capacity while negative changes tend to limit borrowing capacity under our capital investment policy. A very large negative change in the net fair value of our available-for-sale investments securities might impair our liquidity position, requiring us to sell assets with the likely result of realized losses upon sale.

Leverage

Our debt-to-equity ratio at June 30, 2012 and December 31, 2011 was 6.0:1 and 5.4:1, respectively. We generally expect to maintain a ratio of debt-to-equity of less than 12:1. The ratio varies from time to time based upon various factors, including our management’s opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity, the availability of credit, over-collateralization levels required by lenders when we pledge assets to secure borrowings and our assessment of domestic and international market conditions. Our debt-to-equity ratios have been below our historical average ratios since the credit crisis of 2008. Specifically, we believe that it is prudent to maintain our existing debt-to-equity ratio because there continues to be volatility in the mortgage and credit markets primarily driven by the uncertainty in Europe and U.S. capital markets.

Our target debt-to-equity ratio is determined under our capital investment policy. Should our actual debt-to-equity ratio increase above the target level due to asset acquisition or market value fluctuations in assets, we would cease to acquire new assets. Our management will, at that time, present a plan to our board of directors to bring us back to our target debt-to-equity ratio; in many circumstances, this would be accomplished over time by the monthly reduction of the balance of our Agency mortgage-backed securities through principal repayments.

Asset/Liability Management and Effect of Changes in Interest Rates

We continually review our asset/liability management strategy with respect to interest rate risk, mortgage prepayment risk, credit risk and the related issues of capital adequacy and liquidity. Our goal is to provide attractive risk-adjusted stockholder returns while maintaining what we believe is a strong balance sheet.

We seek to manage the extent to which our net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. In addition, we have attempted to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in our portfolio of Agency mortgage-backed securities and Agency debentures by entering into interest rate swaps. At June 30, 2012, we had entered into swap agreements with a total notional amount of \$46.2 billion. We agreed to pay a weighted average pay rate of 2.29% and receive a floating rate based on one month LIBOR. At December 31, 2011, we had entered into swap agreements with a total notional amount of \$40.1 billion. We agreed to pay a weighted average pay rate of 2.55% and receive a floating rate based on one month LIBOR. The weighted average pay rate declined by 0.26% from December 31, 2011 to June 30, 2012. The decline was the direct result of interest rate swaps maturing or terminated with higher pay rates being replaced with interest rate swaps with lower pay rates. We believe that for the immediately foreseeable periods, our weighted average pay rate will continue to decline as a result of interest rate swaps with higher pay rates maturing or being terminated and the replacement of such swaps with interest rate swaps with lower pay rates. We may enter into similar derivative transactions in the future by entering into interest rate collars, caps or floors or purchasing interest only securities. Changes in interest rates may also affect the rate of mortgage principal prepayments and, as a result, prepayments on mortgage-backed securities. We seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets we purchase at a premium with assets we purchase at a discount. To date, the aggregate premium exceeds the aggregate discount on our mortgage-backed securities. As a result, prepayments, which result in the amortization of unamortized premiums, will reduce our net income compared to what net income would be absent such prepayments.

The following table summarizes certain characteristics of our interest rate swaps as of June 30, 2012:

Maturity of Interest Rate Swaps
(dollars in thousands)

| Maturity | Current Notional | Weighted Average Pay Rate | Weighted Average Receive Rate | Weighted Average Years to Maturity |
|--------------------------|------------------|---------------------------------|-------------------------------------|---|
| 0 - 3 years | \$ 14,628,700 | 2.43 % | 0.31 % | 1.74 |
| 3 - 6 years | 23,088,120 | 1.89 % | 0.29 % | 3.91 |
| 6 - 10 years | 4,450,000 | 2.90 % | 0.32 % | 7.55 |
| Greater than 10 years | 4,038,250 | 3.36 % | 0.30 % | 19.16 |
| Total / Weighted Average | \$ 46,205,070 | 2.29 % | 0.30 % | 4.91 |

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide funding to any such entities. As such, we are not materially exposed to any market, credit, liquidity or financing risk that could arise if we had engaged in such relationships.

Capital Resources

At June 30, 2012, we had no material commitments for capital expenditures.

Inflation

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our dividends are based upon our net income as calculated for tax purposes; in each case, our activities and financial condition are measured with reference to historical cost or fair market value without considering inflation.

Other Matters

We calculate that at least 75% of our assets were qualified REIT assets, as defined in the Code, as of June 30, 2012 and December 31, 2011. We also calculate that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the quarter ended June 30, 2012 and the year ended December 31, 2011 and for each quarter therein. Consequently, we met the REIT income and asset tests. We also met all REIT requirements regarding the ownership of our common stock and the distribution of our net income. Therefore, as of June 30, 2012 and December 31, 2011, we believe that we qualified as a REIT under the Code.

We at all times intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, or the Investment Company Act. If we were to become regulated as an investment company, then our use of leverage would be substantially reduced.

We currently rely on the exemption from registration provided by Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C) as interpreted by the staff of the Securities and Exchange Commission (or the SEC), requires us to invest at least 55% of our assets in “mortgages and other liens on and interest in real estate” (or Qualifying Real Estate Assets) and at least 80% of our assets in Qualifying Real Estate Assets plus real estate related assets. The assets that we acquire, therefore, are limited by the provisions of the Investment Company Act and the rules and regulations promulgated under the Investment Company Act.

We rely on an interpretation that “whole pool certificates” that are issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae (or Agency Whole Pool Certificates) are Qualifying Real Estate Assets under Section 3(c)(5)(C). This interpretation was promulgated by the SEC staff in a no-action letter over 30 years ago, was reaffirmed by the SEC in 1992 and has been commonly relied on by mortgage REITs.

On August 31, 2011, the SEC issued a concept release titled “Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments” (SEC Release No. IC-29778). Under the concept release, the SEC is reviewing interpretive issues related to the Section 3(c)(5)(C) exemption. Among other things, the SEC specifically is requesting comments on whether it should revisit whether Agency Whole Pool Certificates may be treated as Qualifying Real Estate Assets and whether entities, such as us, whose primary business consists of investing in Agency Whole Pool Certificates are the type of entities that Congress intended to be encompassed by the exclusion provided by Section 3(c)(5)(C). The potential outcomes of the SEC’s actions are unclear as is the SEC’s timetable for its review and actions.

We determined that as of June 30, 2012 and December 31, 2011, we were in compliance with the exemption from registration provided by Section 3(c)(5)(C) of the Investment Company Act as interpreted by the staff of the SEC.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risk to which we are exposed is interest rate risk, which is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of our Agency mortgage-backed securities and our ability to realize gains from the sale of these assets. We may utilize a variety of financial instruments, including interest rate swaps, caps, floors, inverse floaters and other interest rate exchange contracts, in order to limit the effects of interest rates on our operations. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of securities and that the losses may exceed the amount we invested in the instruments.

Our profitability and the value of our portfolio (including interest rate swaps) may be adversely or positively affected during any period as a result of changing interest rates. The following table quantifies the potential changes in economic net interest income and portfolio value, should interest rates go up or down 25, 50 and 75 basis points, assuming the yield curves of the rate shocks will be parallel to each other and the current yield curve. All changes in income and value are measured as percentage changes from the projected net interest income and portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates at June 30, 2012 and various estimates regarding prepayment and all activities are made at each level of rate shock. Actual results could differ significantly from these estimates.

| Change in Interest Rate | Projected Percentage Change in Economic Net Interest Income(1) | Projected Percentage Change in Portfolio Value, with Effect of Interest Rate Swaps |
|-------------------------|---|--|
| -75 Basis Points | 4.54% | 0.22% |
| -50 Basis Points | 2.80% | 0.04% |
| -25 Basis Points | 1.12% | 0.02% |
| Base Interest Rate | - | - |
| +25 Basis Points | (1.13%) | (0.09%) |
| +50 Basis Points | (2.78%) | (0.27%) |
| +75 Basis Points | (3.91%) | (0.57%) |

(1) Economic net interest income includes interest expense on interest rate swaps.

ASSET AND LIABILITY MANAGEMENT

Asset and liability management is concerned with the timing and magnitude of the repricing of assets and liabilities. We attempt to control risks associated with interest rate movements. Methods for evaluating interest rate risk include an analysis of our interest rate sensitivity "gap", which is the difference between interest-earning assets and interest-bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest-rate sensitive assets exceeds the amount of interest-rate sensitive liabilities. A gap is considered

negative when the amount of interest-rate sensitive liabilities exceeds interest-rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market rates or conditions, changes in interest rates may affect net interest income positively or negatively even if an institution were perfectly matched in each maturity category.

The following table sets forth the estimated maturity or repricing of our interest-earning assets and interest-bearing liabilities at June 30, 2012. The amount of assets and liabilities shown within a particular period were determined in accordance with the contractual terms of the assets and liabilities, except adjustable-rate loans and securities are included in the period in which their interest rates are first scheduled to adjust and not in the period in which they mature and does include the effect of the interest rate swaps. The interest rate sensitivity of our assets and liabilities in the table could vary substantially based on actual prepayment experience.

| | Within 3 Months (dollars in thousands) | 4-12 Months | More than 1 Year to 3 Years | 3 Years and Over | Total |
|--|--|-----------------------|-----------------------------------|---------------------|---------------------|
| Rate Sensitive Assets: | | | | | |
| Cash equivalents | \$924,374 | \$- | \$- | \$- | \$924,374 |
| Reverse repurchase agreements | 2,025,471 | - | - | - | 2,025,471 |
| U.S. Treasury securities | 1,998,363 | - | - | - | 1,998,363 |
| Securities borrowed | 1,465,327 | - | - | - | 1,465,327 |
| Agency Mortgage-backed securities (principal) | 1,493,742 | 1,701,375 | 1,279,925 | 106,192,038 | 110,667,080 |
| Agency debentures (principal) | - | - | 768,390 | 478,060 | 1,246,450 |
| Corporate debt (principal) | 61,665 | - | - | - | 61,665 |
| Total Rate Sensitive Assets | 7,968,942 | 1,701,375 | 2,048,315 | 106,670,098 | 118,388,730 |
| Rate Sensitive Liabilities: | | | | | |
| U.S. Treasury Securities sold, not yet purchased | 1,884,922 | - | - | - | 1,884,922 |
| Repurchase agreements, with the effect of interest rate swaps | 31,278,503 | 17,886,255 | 13,814,089 | 33,781,950 | 96,760,797 |
| Securities loaned | 1,113,107 | - | - | - | 1,113,107 |
| Convertible Senior Notes (principal) | - | - | 1,350,000 | - | 1,350,000 |
| Total Rate Sensitive Liabilities | 34,276,532 | 17,886,255 | 15,164,089 | 33,781,950 | 101,108,826 |
| Interest rate sensitivity gap | \$(26,307,590) | \$(16,184,880) | \$(13,115,774) | \$72,888,148 | \$17,279,904 |
| Cumulative rate sensitivity gap | \$(26,307,590) | \$(42,492,470) | \$(55,608,244) | \$17,279,904 | |
| Cumulative interest rate sensitivity gap as a percentage of total rate-sensitive assets | (22 | %) (36 | %) (47 | %) 15 | % |

Our analysis of risks is based on management's experience, estimates, models and assumptions. These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by our management may produce results that differ significantly from the estimates and assumptions used in our models and the projected results shown in the above tables and in this report. These analyses contain certain forward-looking statements and are subject to the safe harbor statement set forth under the heading, "Special Note Regarding Forward-Looking Statements."

ITEM 4

CONTROLS AND PROCEDURES

Our management, including our Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), reviewed and evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act) as of the end of the period covered by this quarterly report. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, (1) were effective in ensuring that information regarding the Company and its subsidiaries is accumulated and communicated to our management, including our CEO and CFO, by our employees, as appropriate to allow timely decisions regarding required disclosure and (2) were effective in providing reasonable assurance that information the Company must disclose in its periodic reports under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods prescribed by the SEC's rules and forms.

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

From time to time, we are involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on our Consolidated Financial Statements.

Item 1A. RISK FACTORS

There have been no material changes to the risk factors disclosed in Item 1A – Risk Factors of our Annual Report on Form 10-K. The materialization of any risks and uncertainties identified in our Special Note Regarding Forward-Looking Statements contained in this report together with those previously disclosed in our most recent Annual Report on Form 10-K or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Special Note Regarding Forward-Looking Statements” in this quarterly report or our most recent Annual Report on Form 10-K.

Item 6. EXHIBITS

Exhibits:

The exhibits required by this item are set forth on the Exhibit Index attached hereto.

EXHIBIT INDEX

- | | |
|-----|---|
| 3.1 | Articles of Amendment and Restatement of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant’s Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on August 5, 1997). |
| 3.2 | Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant’s Registration Statement on Form S-3 (Registration Statement 333-74618) filed with the Securities and Exchange Commission on June 12, 2002). |
| 3.3 | Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant’s Current Report on Form 8-K (filed with the Securities and Exchange Commission on August 3, 2006). |
| 3.4 | Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.4 of the Registrant’s Quarterly Report on Form 10-Q (filed with the Securities and Exchange Commission on May 7, 2008). |
| 3.5 | Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant’s Current Report on Form 8-K (filed with the Securities and Exchange Commission on June 23, 2011). |

- 3.6 Form of Articles Supplementary designating the Registrant's 7.875% Series A Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share (incorporated by reference to Exhibit 3.3 to the Registrant's Registration Statement on Form 8-A filed April 1, 2004).
- 3.7 Articles Supplementary of the Registrant's designating an additional 2,750,000 shares of the Company's 7.875% Series A Cumulative Redeemable Preferred Stock, as filed with the State Department of Assessments and Taxation of Maryland on October 15, 2004 (incorporated by reference to Exhibit 3.2 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 4, 2004).
- 3.8 Articles Supplementary designating the Registrant's 6% Series B Cumulative Convertible Preferred Stock, liquidation preference \$25.00 per share (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed April 10, 2006).
- 3.9 Articles Supplementary designating the Registrant's 7.625% Series C Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed May 16, 2012).
- 3.1 Amended and Restated Bylaws of the Registrant, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 22, 2011).
- 4.1 Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the Registrant's Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on September 17, 1997).
- 4.2 Specimen Preferred Stock Certificate (incorporated by reference to Exhibit 4.2 to the Registrant's Registration Statement on Form S-3 (Registration No. 333-74618) filed with the Securities and Exchange Commission on December 5, 2001).
- 4.3 Specimen Series A Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form 8-A filed with the Securities and Exchange Commission on April 1, 2004).
- 4.4 Specimen Series B Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on April 10, 2006).
- 4.5 Specimen Series C Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant's Form 8-K filed with the Securities and Exchange Commission on May 16, 2012).
- 4.6 Indenture, dated as of February 12, 2010, between the Registrant and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.1 to the Registrant's Form 8-K filed with the Securities and Exchange Commission on February 12, 2010).
- 4.7 Supplemental Indenture, dated as of February 12, 2010, between the Registrant and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed with the Securities and Exchange Commission on February 12, 2010).
- 4.8 Form of 4.00% Convertible Senior Note due 2015 (included in Exhibit 4.7).
- 4.9 Second Supplemental Indenture, dated as of May 14, 2012, between the Registrant and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed with the Securities and Exchange Commission on May 14, 2012).

- 4.10 Form of 5.00% Convertible Senior Note due 2015 (included in Exhibit 4.9).
- 31.1 Certification of Michael A.J. Farrell, Chairman, Chief Executive Officer, and President of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Kathryn F. Fagan, Chief Financial Officer and Treasurer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Michael A.J. Farrell, Chairman, Chief Executive Officer, and President of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Kathryn F. Fagan, Chief Financial Officer and Treasurer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Exhibit

101.INS

XBRL

Instance Document*

Exhibit

101.SCH

XBRL

Taxonomy Extension Schema Document*

Exhibit

101.CAL

XBRL

Taxonomy Extension Calculation Linkbase Document*

Exhibit

101.DEF

XBRL

Additional Taxonomy Extension Definition Linkbase Document Created*

Exhibit

101.LAB

XBRL

Taxonomy Extension Label Linkbase Document*

Exhibit

101.PRE

XBRL

Taxonomy Extension Presentation Linkbase Document*

* Submitted electronically herewith. Attached as Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Financial Condition at June 30, 2012 (Unaudited) and December 31, 2011 (Derived from the audited consolidated statement of financial condition at December 31, 2011); (ii) Consolidated Statements of Operations and Comprehensive Income (Unaudited) for the quarters ended June 30, 2012 and 2011; (iii) Consolidated Statement of Stockholders' Equity (Unaudited) for the quarters ended June 30, 2012 and 2011; (iv) Consolidated Statements of Cash Flows (Unaudited) for the quarters ended June 30, 2012 and 2011; and (v) Notes to Consolidated Financial Statements (Unaudited). Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ANNALY CAPITAL MANAGEMENT, INC.

Dated: August 7, 2012

By: /s/ Michael A.J. Farrell
Michael A.J. Farrell
(Chairman of the Board, Chief Executive Officer,
President and authorized officer of registrant)

Dated: August 7, 2012

By: /s/ Kathryn F. Fagan
Kathryn F. Fagan
(Chief Financial Officer and Treasurer and
principal financial and chief accounting
officer)