

DYNEX CAPITAL INC
Form 10-Q
August 08, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 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
Commission File Number: 1-9819

DYNEX CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Virginia 52-1549373
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia 23060-9245
(Address of principal executive offices) (Zip Code)

(804) 217-5800
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes R 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 R No £

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

Large accelerated filer £ Accelerated filer R
Non-accelerated filer £ (Do not check if a smaller reporting company) 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 R

On July 31, 2012, the registrant had 54,367,218 shares outstanding of common stock, \$0.01 par value, which is the registrant's only class of common stock.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DYNEX CAPITAL, INC.
CONSOLIDATED BALANCE SHEETS
(amounts in thousands except share data)

	June 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Agency MBS (including pledged of \$2,852,363 and \$1,879,831, respectively)	\$2,979,039	\$1,965,159
Non-Agency MBS (including pledged of \$537,812 and \$415,195, respectively)	558,966	421,096
Securitized mortgage loans, net	89,225	113,703
Other investments, net	933	1,018
	3,628,163	2,500,976
Cash and cash equivalents	53,763	48,776
Principal receivable on investments	16,592	13,826
Accrued interest receivable	17,618	12,609
Other assets, net	13,061	6,006
Total assets	\$3,729,197	\$2,582,193
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	\$3,111,924	\$2,093,793
Payable for securities pending settlement	502	—
Non-recourse collateralized financing	31,561	70,895
Derivative liabilities	39,267	27,997
Accrued interest payable	1,991	2,165
Accrued dividends payable	15,766	11,307
Other liabilities	3,113	4,687
Total liabilities	3,204,124	2,210,844
Commitments and Contingencies (Note 12)		
Shareholders' equity:		
Common stock, par value \$.01 per share, 100,000,000 shares authorized; 54,366,382 and 40,382,530 shares issued and outstanding, respectively	544	404
Additional paid-in capital	759,167	634,683
Accumulated other comprehensive income (loss)	21,505	(3,255)
Accumulated deficit	(256,143)	(260,483)
Total shareholders' equity	525,073	371,349
Total liabilities and shareholders' equity	\$3,729,197	\$2,582,193

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

(amounts in thousands except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Interest income:				
Agency MBS	\$18,181	\$15,244	\$35,107	\$26,762
Non-Agency MBS	7,338	3,830	14,875	7,521
Securitized mortgage loans	1,527	1,961	3,031	4,180
Other investments	79	30	384	67
	27,125	21,065	53,397	38,530
Interest expense:				
Repurchase agreements	7,863	4,760	14,507	8,188
Non-recourse collateralized financing	254	1,272	735	2,578
	8,117	6,032	15,242	10,766
Net interest income	19,008	15,033	38,155	27,764
Provision for loan losses	—	(200	) (60	) (450
Net interest income after provision for loan losses	19,008	14,833	38,095	27,314
Gain on sale of investments, net	2,587	742	2,938	742
Fair value adjustments, net	117	131	(93	) 5
Other income, net	159	143	528	186
General and administrative expenses:				
Compensation and benefits	(1,779	) (1,209	) (3,577	) (2,341
Other general and administrative	(1,245	) (1,046	) (2,568	) (2,032
Net income	\$18,847	\$13,594	\$35,323	\$23,874
Weighted average common shares:				
Basic	54,354	40,333	51,931	36,763
Diluted	54,354	40,334	51,931	36,765
Net income per common share:				
Basic	\$0.35	\$0.34	\$0.68	\$0.65
Diluted	\$0.35	\$0.34	\$0.68	\$0.65
Dividends declared per common share	\$0.29	\$0.27	\$0.57	\$0.54

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(amounts in thousands)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Net income	\$18,847	\$13,594	\$35,323	\$23,874
Other comprehensive income:				
Change in market value of available-for-sale investments	9,766	12,796	35,766	6,165
Reclassification adjustment for gain on sale of investments, net	—	(742)	—	(742)
Net unrealized gain on cash flow hedging instruments	(11,184)	(11,738)	(11,005)	(8,781)
Other comprehensive income (loss)	(1,418)	316	24,761	(3,358)
Total comprehensive income	\$17,429	\$13,910	\$60,084	\$20,516

See notes to unaudited consolidated financial statements.

DYNEX CAPITAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(amounts in thousands)

	Six Months Ended	
	June 30,	
	2012	2011
Operating activities:		
Net income	\$35,323	\$23,874
Adjustments to reconcile net income to cash provided by operating activities:		
Increase in accrued interest receivable	(5,009	) (5,275
(Decrease) increase in accrued interest payable	(174	) 358
Provision for loan losses	60	450
Gain on sale of investments, net	(2,938	) (742
Fair value adjustments, net	93	(5
Amortization and depreciation	33,012	11,427
Stock-based compensation expense	920	353
Cash payments on stock appreciation rights	(21) —
Net change in other assets and other liabilities	(2,481	) 2,840
Net cash and cash equivalents provided by operating activities	58,785	33,280
Investing activities:		
Purchase of investments	(1,517,541	) (1,244,687
Principal payments received on investments	269,642	207,014
Increase in principal receivable on investments	(2,766	) (10,663
Proceeds from sales of investments	106,206	35,351
Principal payments received on securitized mortgage loans	16,408	21,417
Other investing activities	(1,707	) (204
Net cash and cash equivalents used in investing activities	(1,129,758	) (991,772
Financing activities:		
Borrowings under repurchase agreements, net	1,018,131	899,066
Principal payments on non-recourse collateralized financing	(39,455	) (1,600
Proceeds from issuance of common stock	123,808	95,242
Dividends paid	(26,524	) (19,077
Net cash and cash equivalents provided by financing activities	1,075,960	973,631
Net increase in cash and cash equivalents	4,987	15,139
Cash and cash equivalents at beginning of period	48,776	18,836
Cash and cash equivalents at end of period	\$53,763	\$33,975
Supplemental Disclosure of Cash Activity:		
Cash paid for interest	\$15,314	\$9,881

See notes to unaudited consolidated financial statements.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.

(amounts in thousands except share and per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements of Dynex Capital, Inc. and its qualified real estate investment trust (“REIT”) subsidiaries and its taxable REIT subsidiary (together, “Dynex” or the “Company”) have been prepared in accordance with the instructions to the Quarterly Report on Form 10-Q and Article 10, Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America (“GAAP”) for complete financial statements. In the opinion of management, all significant adjustments, consisting of normal recurring accruals considered necessary for a fair presentation of the consolidated financial statements, have been included. Operating results for the three and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2012. The unaudited consolidated financial statements included herein should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC.

Consolidation

The consolidated financial statements include the accounts of the Company, its qualified REIT subsidiaries and its taxable REIT subsidiary. The consolidated financial statements represent the Company’s accounts after the elimination of intercompany balances and transactions. The Company consolidates entities in which it owns more than 50% of the voting equity and control does not rest with others and variable interest entities in which it is determined to be the primary beneficiary in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 810-10. The Company follows the equity method of accounting for investments with greater than a 20% and less than 50% interest in partnerships and corporate joint ventures or when it is able to influence the financial and operating policies of the investee but owns less than 50% of the voting equity. As of June 30, 2012 and December 31, 2011, the Company did not have any investments in which it owned less than a 50% interest in the voting equity.

In accordance with ASC Topic 810-10, the Company also consolidates certain trusts through which it has securitized mortgage loans. Additional information regarding the accounting policy for securitized mortgage loans is provided below under “Investments”.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management include but are not limited to fair value measurements of its investments, allowance for loan losses, other-than-temporary impairments, commitments and contingencies, and amortization of premiums and discounts. These items are discussed further below within this note to the consolidated financial statements.

Federal Income Taxes

The Company believes it has complied with the requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). As such, the Company believes that it qualifies as a REIT for federal income tax purposes, and it generally will not be subject to federal income tax on the amount of its income or gain that is distributed as dividends to shareholders. The Company uses the calendar year for both tax and financial reporting purposes. There may be differences between taxable income and income computed in accordance with GAAP.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

Investments

The Company's investments include Agency MBS, non-Agency MBS, securitized mortgage loans, and other investments.

Agency MBS. The Company accounts for its investment in Agency MBS in accordance with ASC Topic 320, which requires that investments in debt and equity securities be designated as either "held-to-maturity," "available-for-sale" or "trading" at the time of acquisition. As of June 30, 2012, the majority of the Company's Agency MBS are designated as available-for-sale with the remainder designated as trading. Although the Company generally intends to hold its available-for-sale securities until maturity, it may, from time to time, sell any of these securities as part of the overall management of its business. The available-for-sale designation provides the Company with this flexibility.

All of the Company's Agency MBS are recorded at their fair value on the consolidated balance sheet. In accordance with ASC Topic 820, the Company determines the fair value of its Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The Company's application of ASC Topic 820 guidance is discussed further in Note 10. Changes in the fair value of Agency MBS designated as trading are recognized in net income within "fair value adjustments, net". Gains (losses) realized upon the sale, impairment, or other disposal of a trading security are also recognized within "fair value adjustments, net". Alternatively, changes in the fair value of Agency MBS designated as available-for-sale are reported in other comprehensive income as unrealized gains (losses) until the security is collected, disposed of, or determined to be other than temporarily impaired. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income ("AOCI") into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

Non-Agency MBS. The Company accounts for its investment in non-Agency MBS in accordance with ASC Topic 320. As of June 30, 2012, all of the Company's non-Agency MBS are designated as available-for-sale and are recorded at their fair value on the consolidated balance sheet. Changes in fair value are reported in other comprehensive income until the security is collected, disposed of, or determined to be other than temporarily impaired. Like Agency MBS, the Company generally intends to hold its investments in non-Agency MBS until maturity, but it may, from time to time sell any of these securities as part of the overall management of its business. Upon the sale of an available-for-sale security, any unrealized gain or loss is reclassified out of AOCI into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

In accordance with ASC Topic 820, the Company determines the fair value for the majority of its non-Agency MBS based upon prices obtained from a third-party pricing service and broker quotes. The remainder of the non-Agency MBS are valued by discounting the estimated future cash flows derived from cash flow models that utilize information such as the security's coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected losses, credit enhancement, as well as certain other relevant information.

Other-than-Temporary Impairment. The Company evaluates all MBS in its investment portfolio for other-than-temporary impairments by applying the guidance prescribed in ASC Topic 320-10. If the Company has decided to sell an investment in MBS with a fair value less than its amortized cost as of the balance sheet date of a reporting period, the MBS is considered to be other-than-temporarily impaired, and the Company will recognize an other-than-temporary impairment in the related period's income statement equal to the entire difference between the amortized cost basis and the fair value of the MBS as of the balance sheet date. If the Company does not intend to sell

the MBS, the Company assesses whether it is more likely than not will be able to recover its entire amortized cost basis before it is sold. If the Company determines that it will not be able to recover the entire amortized cost basis of the MBS before it is sold, the Company recognizes in the related period's income statement the difference between the present value of cash flows expected to be collected and the amortized cost basis of the debt security as an other-than-temporary impairment related to credit loss, and the difference between the amortized cost basis and the fair value of the MBS as of the balance sheet date is recognized in other comprehensive income.

In periods after the recognition of an other-than-temporary impairment loss for MBS, the Company shall account for the

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other-than-temporarily impaired MBS as if the MBS had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized in earnings. For MBS for which other-than-temporary impairments were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted into interest income using the effective interest method. The Company shall continue to estimate the present value of cash flows expected to be collected over the life of the MBS. For all other MBS, if upon subsequent evaluation, there is an increase in the cash flows expected to be collected or if actual cash flows are greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with Subtopic 310-30 even if the MBS would not otherwise be within the scope of that Subtopic. Subsequent increases and decreases in the fair value of the MBS that are not other-than-temporary shall be included in other comprehensive income.

Please see Note 10 for additional information related to the Company's evaluation for other-than-temporary impairments.

Securitized Mortgage Loans. Securitized mortgage loans consist of loans pledged to support the repayment of securitization financing bonds that were issued by the Company prior to 2000. The associated securitization financing bonds are treated as debt of the Company and are presented as a portion of "non-recourse collateralized financing" on the consolidated balance sheet. In accordance with ASC Topic 310-10, the Company's securitized mortgage loans are reported at amortized cost. Securitized mortgage loans can only be sold subject to the lien of the respective securitization financing indenture. An allowance has been established for currently existing and probable losses on such loans as further discussed below.

Other Investments. Other investments include unsecuritized single-family and commercial mortgage loans which are carried at amortized cost in accordance with ASC Topic 310-10. An allowance has been established for currently existing and probable losses on these loans as further discussed below.

Allowance for Loan Losses. An allowance for loan losses has been estimated and established for currently existing and probable losses for securitized and unsecuritized mortgage loans that are considered impaired in accordance with ASC Topic 310-10. Provisions made to increase the allowance are charged as a current period expense. Commercial mortgage loans are secured by income-producing real estate and are evaluated individually for impairment when the debt service coverage ratio on the mortgage loan is less than 1:1 or when the mortgage loan is delinquent. Commercial mortgage loans not evaluated for individual impairment are evaluated for a general allowance. Certain of the commercial mortgage loans are covered by mortgage loan guarantees that limit the Company's exposure on these mortgage loans. Single-family mortgage loans are considered homogeneous and are evaluated on a pool basis for a general allowance.

The Company considers various factors in determining its specific and general allowance requirements, including whether a loan is delinquent, the Company's historical experience with similar types of loans, historical cure rates of delinquent loans, and historical and anticipated loss severity of the mortgage loans as they are liquidated. The factors may differ by mortgage loan type (e.g., single-family versus commercial) and collateral type (e.g., multifamily versus office property). The allowance for loan losses is evaluated and adjusted periodically by management based on the actual and estimated timing and amount of probable credit losses, using the above factors, as well as industry loss experience.

Repurchase Agreements

Repurchase agreements are treated as financings in accordance with the provision of ASC Topic 860 under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the

estimated fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. Most of the Company's repurchase agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

Derivative Instruments

The Company may enter into interest rate swap agreements, interest rate cap agreements, interest rate floor agreements, financial forwards, financial futures and options on financial futures (“interest rate agreements”) to manage its sensitivity to changes in interest rates. The Company accounts for its interest rate agreements under ASC Topic 815, designating each as either a cash flow hedging position or a trading position using criteria established therein. In order to qualify as a cash flow hedge, ASC Topic 815 requires formal documentation to be prepared at the inception of the interest rate agreement that meets certain conditions. If these conditions are not met, an interest rate agreement will be classified as a trading position.

For interest rate agreements designated as trading positions, the Company records these instruments at fair value on the Company’s balance sheet in accordance with ASC Topic 815. Changes in their market value are measured at each reporting date and recognized in the current period’s consolidated statement of income within “fair value adjustments, net”.

For interest rate agreements designated as cash flow hedges, the Company evaluates the effectiveness of these hedges against the financial instrument being hedged. The effective portion of the hedge relationship on an interest rate agreement designated as a cash flow hedge is reported in AOCI and is later reclassified into the consolidated statement of income in the same period during which the hedged transaction affects earnings. The ineffective portion of such hedge is immediately reported in the current period’s consolidated statement of income. These derivative instruments are carried at fair value on the Company’s consolidated balance sheet in accordance with ASC Topic 815. Cash posted to meet margin calls, if any, is included on the consolidated balance sheet in other assets.

In the event a hedging instrument is terminated, any basis adjustments or changes in the fair value of hedges recorded in AOCI are recognized into income or expense in conjunction with the original hedge or hedged exposure.

If the underlying asset, liability or commitment is sold or matures, the hedge is deemed partially or wholly ineffective, or if the criterion that was established at the time the hedging instrument was entered into no longer exists, the interest rate agreement no longer qualifies as a designated hedge. Under these circumstances, such changes in the market value of the interest rate agreement are recognized in the current period’s statement of income.

The Company has elected to use the portfolio exception in ASC 820-10-35-18D with respect to measuring counterparty credit risk for derivative instruments. The Company manages credit risk for its derivative positions on a counterparty-by-counterparty basis (that is, on the basis of its net portfolio exposure with each counterparty), consistent with its risk management strategy for such transactions. The Company manages credit risk by considering indicators of risk such as credit ratings, and by negotiating terms in its ISDA master netting arrangements and, if applicable, any associated Credit Support Annex documentation, with each individual counterparty. Since the effective date of ASC 820, management has monitored and measured credit risk and calculated credit valuation adjustments for its derivative transactions on the basis of its relationships at the counterparty portfolio level. Management receives reports from an independent third-party valuation specialist on a monthly basis providing the credit valuation adjustments at the counterparty portfolio level for purposes of reviewing and managing its credit risk exposures. Since the portfolio exception applies only to the fair value measurement and not to financial statement presentation, the portfolio-level adjustments are then allocated in a reasonable and consistent manner each period to the individual assets or liabilities that make up the group, in accordance with other applicable accounting guidance and the Company's accounting policy elections.

Interest Income, Premium Amortization, and Discount Accretion

Interest income is accrued based on the outstanding principal balance (or notional balance in the case of interest-only, or "IO", securities) on the Company's investment securities and their contractual terms. Premiums and discounts on Agency and non-Agency MBS and on loans are recognized over the expected life of the investment using the effective yield method in accordance with ASC Topic 310-20. Adjustments to premium amortization are made for actual prepayment activity as well as changes in projected future cash flows. Interest income on non-Agency MBS that are rated lower than "AA" are recognized over the expected life as adjusted for the estimated prepayments and credit losses of the securities in accordance with ASC Topic 310-30. Actual prepayment and credit loss experience is reviewed and effective yields are adjusted when projected prepayments and credit losses differ from the amounts actually received as well as for changes in anticipated future prepayments.

The Company's projections of future cash flows are based on input and analysis received from external sources and

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internal models, and includes assumptions about the amount and timing of credit losses, loan prepayment rates, fluctuations in interest rates, and other factors. On at least a quarterly basis, the Company reviews and makes any necessary adjustments to its cash flow projections and updates the yield recognized on these assets.

For securities, the accrual of interest is discontinued when, in the opinion of management, it is probable that all amounts contractually due will not be collected, and in certain instances, as a result of the other-than-temporary impairment analysis. For loans, the accrual of interest is discontinued when, in the opinion of management, the interest is not collectible in the normal course of business, when the loan is significantly past due or when the primary servicer of the loan fails to advance the interest and/or principal due on the loan. Loans are considered past due when the borrower fails to make a timely payment in accordance with the underlying loan agreement. All interest accrued but not collected for investments that are placed on a non-accrual status or are charged-off is reversed against interest income. Interest on these investments is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual status. Investments are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Stock-Based Compensation

Pursuant to the Company's 2009 Stock and Incentive Plan ("SIP"), the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights ("SARs"), dividend equivalent rights, performance shares, and restricted stock units. Currently, the Company's stock options and restricted stock issued under this plan may be settled only in shares of its common stock, and therefore are treated as equity awards with their fair value measured at the grant date as required by ASC Topic 718. Outstanding SARs issued by the Company may be settled only in cash, and therefore have been treated as liability awards with their fair value estimated at the grant date and remeasured at the end of each reporting period using the Black-Scholes option valuation model as required by ASC Topic 718. Please see Note 11 for additional disclosures regarding the Company's SIP.

Contingencies

In the normal course of business, there are various lawsuits, claims, and other contingencies pending against the Company. We evaluate whether to establish provisions for estimated losses from those matters in accordance with ASC Topic 450, which states that a liability is recognized for a contingent loss when: (a) the underlying causal event has occurred prior to the balance sheet date; (b) it is probable that a loss has been incurred; and (c) there is a reasonable basis for estimating that loss. A liability is not recognized for a contingent loss when it is only possible or remote that a loss has been incurred, however, possible contingent losses shall be disclosed. Please refer to Note 12 for details on the most significant matters currently pending.

Recent Accounting Pronouncements

There are no recently issued accounting pronouncements that are expected to materially impact the Company's financial condition or results of operations which are not effective as of the date of this Quarterly Report on Form 10-Q for the three months ended June 30, 2012.

In December 2011, FASB issued Accounting Standards Update ("ASU") No. 2011-11 which amends ASC Topic 210 to require an entity to disclose information about offsetting assets and liabilities and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. Offsetting, otherwise known as netting, is the presentation of assets and liabilities as a single net amount in the balance sheet. GAAP gives companies the option to present in their consolidated balance sheets, on a net basis, derivatives that are subject to a legally enforceable netting arrangement with the same party where rights of set-off are only available in

the event of default or bankruptcy. This amendment is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods, and should be applied retrospectively for all comparative periods presented. The Company does not currently offset any of its assets and liabilities, and as such, does not anticipate that ASU No. 2011-11 will have a material impact on the Company's financial condition or results of operations.

NOTE 2 – NET INCOME PER COMMON SHARE

Net income per common share is presented on both a basic and diluted basis. Diluted net income per common share assumes the exercise of stock options using the treasury stock method. The following table presents the calculation of the numerator and denominator for both basic and diluted net income per common share:

	Three Months Ended		2011	
	June 30, 2012	Weighted-Average Common Shares	Income	Weighted-Average Common Shares
Net income	\$18,847	54,353,811	\$13,594	40,333,269
Effect of dilutive stock options	—	—	—	1,138
Diluted	\$18,847	54,353,811	\$13,594	40,334,407
Net income per common share:				
Basic		\$ 0.35		\$0.34
Diluted ⁽¹⁾		\$ 0.35		\$0.34

For the three months ended June 30, 2012 and June 30, 2011, the calculation of diluted net income per common (1) share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

	Six Months Ended		2011	
	June 30, 2012	Weighted-Average Common Shares	Income	Weighted-Average Common Shares
Net income	\$35,323	51,930,581	\$23,874	36,762,811
Effect of dilutive stock options	—	—	—	2,209
Diluted	\$35,323	51,930,581	\$23,874	36,765,020
Net income per common share:				
Basic		\$ 0.68		\$0.65
Diluted ⁽¹⁾		\$ 0.68		\$0.65

(1) For the six months ended June 30, 2012, the calculation of diluted net income per common share excludes the effect of 15,000 unexercised stock option awards because their inclusion would have been anti-dilutive.

NOTE 3 – AGENCY MBS

The following table presents the components of the Company's investment in Agency MBS as of June 30, 2012 and December 31, 2011:

	June 30, 2012			Total
	RMBS	CMBS	CMBS IO ⁽¹⁾	
Principal/par value	\$2,216,357	\$286,982	\$—	\$2,503,339
Unamortized premium	120,828	22,412	295,046	438,286
Unamortized discount	(15)	—	—	(15)
Amortized cost	2,337,170	309,394	295,046	2,941,610
Available for sale (recognized in statement of comprehensive income):				
Gross unrealized gains	19,409	17,047	5,892	42,348
Gross unrealized losses	(6,175)	—	(1,060)	(7,235)
Trading (recognized in income statement):				
Gross unrealized gains	—	2,316	—	2,316
Total Agency MBS fair value:	\$2,350,404	\$328,757	\$299,878	\$2,979,039
Weighted average coupon	3.87	% 5.19	% 1.17	% 4.02

(1) The combined notional balance for the Agency CMBS IO securities is \$4,543,349 as of June 30, 2012.

	December 31, 2011			Total
	RMBS	CMBS	CMBS IO ⁽¹⁾	
Principal/par value	\$1,488,397	\$266,952	\$—	\$1,755,349
Unamortized premium	85,488	21,627	86,358	193,473
Unamortized discount	(17)	—	—	(17)
Amortized cost	1,573,868	288,579	86,358	1,948,805
Available for sale (recognized in statement of comprehensive income):				
Gross unrealized gains	10,787	11,746	350	22,883
Gross unrealized losses	(7,405)	—	(1,043)	(8,448)
Trading (recognized in income statement):				
Gross unrealized gains	—	1,919	—	1,919
Total Agency MBS fair value:	\$1,577,250	\$302,244	\$85,665	\$1,965,159
Weighted average coupon	4.54	% 5.20	% 0.96	% 4.64

(1) The combined notional balance for the Agency CMBS IO securities is \$1,813,096 as of December 31, 2011,

The Company purchased \$1,020,900 of Agency RMBS and \$247,481 of Agency CMBS, consisting principally of CMBS IOs, since December 31, 2011. Agency CMBS IOs are secured by excess interest payments on pools of multifamily housing mortgage loans. As these securities have no principal associated with them, the interest payments received are based on the unpaid principal balance (often referred to as the notional amount) of the underlying pool of mortgage loans. The IO securities have prepayment protection in the form of lock-outs and/or yield maintenance associated with the underlying loans.

As of June 30, 2012 and December 31, 2011, the amortized cost of Agency CMBS designated as trading was \$27,833 and \$28,119, respectively. The Company recognized a net unrealized gain for the three and six months ended June 30, 2012 of \$569 and \$433 compared to \$956 and \$1,075 for the three and six ended June 30, 2011, respectively, related to changes in fair

value, which is included within "fair value adjustments, net" in the Company's consolidated statements of income. The Company also has derivatives designated as trading instruments, and the changes in their fair value are also included within "fair value adjustments, net". Please refer to Note 7 for additional information on these derivatives designated as trading instruments.

NOTE 4 – NON-AGENCY MBS

The following table presents the components of the Company's non-Agency MBS as of June 30, 2012 and December 31, 2011:

	June 30, 2012			
	RMBS	CMBS	CMBS IO ⁽¹⁾	Total
Principal/par value	\$19,282	\$473,198	\$—	\$492,480
Unamortized premium	4	3,018	63,601	66,623
Unamortized discount	(855)	(22,123)	—	(22,978)
Amortized cost	18,431	454,093	63,601	536,125
Gross unrealized gains	478	22,031	2,471	24,980
Gross unrealized losses	(801)	(1,256)	(82)	(2,139)
Fair value	\$18,108	\$474,868	\$65,990	\$558,966
Weighted average coupon	4.43 %	5.47 %	1.26 %	5.43 %

(1) The combined notional balance for the non-Agency CMBS IO securities is \$1,011,637 as of June 30, 2012.

	December 31, 2011			
	RMBS	CMBS	CMBS IO ⁽¹⁾	Total
Principal/par value	\$17,119	\$359,853	\$—	\$376,972
Unamortized premium	—	3,646	51,239	54,885
Unamortized discount	(1,003)	(17,511)	—	(18,514)
Amortized cost	16,116	345,988	51,239	413,343
Gross unrealized gains	507	11,806	893	13,206
Gross unrealized losses	(1,353)	(3,724)	(376)	(5,453)
Fair value	\$15,270	\$354,070	\$51,756	\$421,096
Weighted average coupon	4.41 %	5.91 %	1.24 %	5.85 %

(1) The combined notional balance for the non-Agency CMBS IO securities is \$906,202 as of December 31, 2011.

All of the Company's non-Agency MBS are designated as available-for-sale and are comprised primarily of investment-grade rated securities. The Company purchased \$120,697 of non-Agency CMBS since December 31, 2011. In addition, the Company paid premiums of \$16,000 for non-Agency CMBS IO securities.

NOTE 5 – SECURITIZED MORTGAGE LOANS, NET

The Company's securitized mortgage loans are pledged as collateral for its associated securitization financing bonds, which are discussed further in Note 9. Please also refer to Note 6 for disclosures related to impaired securitized mortgage loans and the related allowance for loans losses. The following table summarizes the components of securitized mortgage loans as of June 30, 2012 and December 31, 2011:

	June 30, 2012			December 31, 2011		
	Commercial	Single-family	Total	Commercial	Single-family	Total
Principal/par value ⁽¹⁾	\$46,079	\$44,191	\$90,270	\$68,029	\$47,657	\$115,686
Unamortized premium, net	—	666	666	—	770	770
Unamortized discount, net	(125)	—	(125)	(254)	—	(254)
Amortized cost	45,954	44,857	90,811	67,775	48,427	116,202
Allowance for loan losses	(1,355)	(231)	(1,586)	(2,268)	(231)	(2,499)
	\$44,599	\$44,626	\$89,225	\$65,507	\$48,196	\$113,703

(1) Includes funds held by trustees.

The balance of the Company's securitized commercial mortgage loans has decreased since December 31, 2011 primarily due to principal payments, including amounts received on defeased loans, of \$18,110. The Company's securitized commercial mortgage loans were originated principally in 1996 and 1997 and are collateralized by first deeds of trust on income producing properties. Approximately 72% of these securitized commercial mortgage loans are secured by multifamily properties. As of June 30, 2012 and December 31, 2011, the loan-to-value ratio based on original appraisal was 41% and 42%, respectively. The unpaid principal balance of the securitized commercial mortgage loans identified as seriously delinquent (60 or more days past due) and therefore on nonaccrual status is \$710 as of June 30, 2012 compared to \$14,997 as of December 31, 2011.

The balance of the Company's securitized single-family mortgage loans have decreased since December 31, 2011 due to principal payments on the loans of \$3,467. These single-family mortgage loans are secured by first deeds of trust on residential real estate and were originated principally from 1992 to 1997. As of June 30, 2012 and December 31, 2011, the current loan-to-value ratio based on original appraisal was approximately 44% and 46%, respectively. The unpaid principal balance of the Company's securitized single-family mortgage loans identified as seriously delinquent as of June 30, 2012 is \$3,663 compared to \$3,366 as of December 31, 2011. The Company continues accruing interest on any seriously delinquent securitized single-family mortgage loan so long as the primary servicer continues to advance the interest and/or principal due on the loan.

NOTE 6 – ALLOWANCE FOR LOAN LOSSES

As discussed in Note 1, the Company estimates for currently existing and probable losses for its mortgage loans that are considered impaired. A loan can be considered impaired even if it is not delinquent. The following table summarizes the aggregate activity for the portion of the allowance for loan losses that relates to the securitized mortgage loan portfolio for the periods indicated:

	Three Months Ended			
	June 30, 2012		2011	
	Commercial	Single-family	Commercial	Single-family
Allowance at beginning of period	\$1,341	\$231	\$4,237	\$249
Provision for loan losses	—	—	200	—
Credit losses, net of recoveries	14	—	(1,368)	(41)
Allowance at end of period	\$1,355	\$231	\$3,069	\$208

	Six Months Ended			
	June 30, 2012		2011	
	Commercial	Single-family	Commercial	Single-family
Allowance at beginning of period	\$2,268	\$231	\$4,200	\$270
Provision for loan losses	60	—	450	—
Credit losses, net of recoveries	(973	) —	(1,581	) (62
Allowance at end of period	\$1,355	\$231	\$3,069	\$208

The following table presents certain information on impaired securitized commercial and single-family mortgage loans as of June 30, 2012 and December 31, 2011:

	June 30, 2012		December 31, 2011	
	Commercial	Single-family	Commercial	Single-family
Unpaid principal balance of impaired securitized loans	\$1,776	\$3,663	\$4,724	\$3,000
Basis adjustments related to impaired securitized loans	1	55	8	48
Amortized cost basis of impaired securitized loans	1,777	3,718	4,732	3,048
Allowance for loan losses	(1,355	) (231	) (2,268	) (231
Investment in excess of allowance	\$422	\$3,487	\$2,464	\$2,817

The Company recognized \$25 and \$50 of interest income on impaired securitized commercial mortgage loans for the three and six months ended June 30, 2012, respectively, compared to \$28 and \$56 of interest income for the three and six months ended June 30, 2011, respectively. The Company recognized \$51 and \$102 of interest income on impaired securitized single-family mortgage loans for the three and six months ended June 30, 2012, respectively, compared to \$71 and \$143 of interest income for the three and six months ended June 30, 2011, respectively.

NOTE 7 – DERIVATIVES

As of June 30, 2012 and December 31, 2011, the Company's derivative financial instruments are comprised entirely of interest rate swaps, and are designated as either hedging instruments or trading instruments. The tables below summarize information about the Company's derivative financial instruments on the balance sheet as of the dates indicated:

Accounting Designation:	Balance Sheet Location:	June 30, 2012				December 31, 2011			
		Fair Value	Cumulative Notional Amount	Weighted-average Fixed Rate Swapped		Fair Value	Cumulative Notional Amount	Weighted-average Fixed Rate Swapped	
Hedging instruments		\$(36,551)	\$1,485,000	1.50	%	\$(25,512)	\$1,065,000	1.55	%
Trading instruments		(2,716)	27,000	2.88	%	(2,485)	27,000	2.88	%
	Derivative liabilities	\$(39,267)				\$(27,997)			

Included in the balance as of June 30, 2012 are seven forward-starting interest rate swaps with a combined notional balance of \$275,000 and a weighted average pay-fixed rate of 1.62% which are not effective until 2013.

The following table summarizes the contractual maturities remaining for the Company's outstanding interest rate swap agreements as of June 30, 2012:

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Remaining Maturity	Notional Amount:			Number of Swaps	Weighted-Average Fixed Rate Swapped	
	Trading	Hedging	Total			
0-12 months	\$—	\$75,000	\$75,000	2	1.30	%
13-36 months	—	565,000	565,000	10	1.44	%
37-60 months	27,000	260,000	287,000	11	2.04	%
Over 60 months	—	585,000	585,000	19	1.39	%
	\$27,000	\$1,485,000	\$1,512,000	42	1.53	%

The table below provides additional information related to the forward-starting swaps that are included in the preceding table:

Forward-Start Date	Notional Amount	Weighted-Average Fixed Rate Swapped	
March 25, 2013	\$100,000	1.89	%
April 15, 2013	25,000	1.70	%
January 8, 2013	150,000	0.77	%
	\$275,000	1.62	%

With respect to hedging instruments, the Company's objective for using interest rate swaps is to minimize its exposure to the risk of increased interest expense resulting from its existing and forecasted short-term, fixed-rate borrowings. The Company continuously borrows funds via sequential fixed-rate, short-term repurchase agreement borrowings. As each fixed-rate repurchase agreement matures, it is replaced with new fixed-rate agreements based on the market interest rate in effect at the time of such replacement. This sequential rollover borrowing program creates a variable interest expense pattern. The changes in the cash flows of the interest rate swaps are expected to be highly effective at offsetting changes in the interest portion of the cash flows expected to be paid at maturity of each borrowing.

The table below presents the effect of the derivatives designated as hedging instruments on the Company's consolidated statement of comprehensive income for the periods indicated:

Type of Derivative Designated as Cash Flow Hedge	Amount of Gain (Loss) Recognized in OCI (Effective Portion)	Location of Amount Reclassified from OCI into Net Income (Effective Portion)	Amount Reclassified from OCI into Net Income (Effective Portion)	Location of Loss Recognized in Net Income (Ineffective Portion)	Amount of Gain (Loss) Recognized in Net Income (Ineffective Portion)
For the three months ended June 30, 2012:					
Interest rate swaps	\$(14,693)	Interest expense	\$3,509	Other income, net	\$131
For the three months ended June 30, 2011:					
Interest rate swaps	\$(14,810)	Interest expense	\$3,072	Other income, net	\$(25)
For the six months ended June 30, 2012:					
Interest rate swaps	\$(17,780)	Interest expense	\$6,775	Other income, net	\$69
For the six months ended June 30, 2011:					
Interest rate swaps	\$(13,722)	Interest expense	\$4,941	Other income, net	\$(24)

The table below presents a rollforward of the activity in the Company's AOCI related to its derivatives designated as hedging instruments for the periods presented:

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	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Balance as of beginning of period	\$(25,265)	\$137	\$(25,444)	\$(2,820)
Change in fair value of interest rate swaps	(14,693)	(14,810)	(17,780)	(13,722)
Reclassification adjustment for amounts included in statement of income	3,509	3,072	6,775	4,941
Balance as of end of period	\$(36,449)	\$(11,601)	\$(36,449)	\$(11,601)

The Company estimates that \$15,139 of the existing losses that are reported in AOCI as of June 30, 2012 is expected to be reclassified into earnings as an increase to interest expense within the next 12 months.

The Company's objective for designating certain interest rate swaps as trading instruments is to offset the changes in market value for a portion of its Agency CMBS investments that are also designated as trading. The table below presents the effect of the derivatives designated as trading instruments on the Company's consolidated statements of income for the periods indicated.

Type of Derivative Designated as Trading	Location On Income Statement	Amount of Loss Recognized in Net Income			
		Three Months Ended		Six Months Ended	
		June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Interest rate swaps	Fair value adjustments, net	\$(500)	\$(871)	\$(574)	\$(1,204)

These interest rate swap agreements contain various covenants related to the Company's credit risk. Specifically, if the Company defaults on any of its indebtedness, including those circumstances whereby repayment of the indebtedness has not been accelerated by the lender, or is declared in default of any of its covenants with any counterparty, then the Company could also be declared in default of its derivative obligations. Additionally, the agreements outstanding with its derivative counterparties allow those counterparties to require settlement of its outstanding derivative transactions if the Company fails to earn GAAP net income greater than one dollar as measured on a rolling two quarter basis. These interest rate agreements also contain provisions whereby, if the Company fails to maintain a minimum net amount of shareholders' equity, then the Company may be declared in default on its derivative obligations. As of June 30, 2012, the Company had derivatives in a net liability position with its derivative counterparties for which it had pledged Agency MBS with a fair value of \$43,328 and cash of \$38 as collateral. If the Company had breached any of these agreements as of June 30, 2012, it could have been required to settle those derivatives at their estimated termination value of \$39,921, which includes accrued interest but excludes any adjustment for nonperformance risk.

NOTE 8 – REPURCHASE AGREEMENTS

The Company uses repurchase agreements, which are recourse to the Company, to finance certain of its investments. As of June 30, 2012, the Company had repurchase agreement borrowings outstanding with a weighted average rate of 0.62% with 20 of its 26 available repurchase agreement counterparties compared to a weighted average borrowing rate of 0.61% with 20 counterparties as of December 31, 2011. The Company had approximately 11% of its shareholders' equity at risk with one counterparty, Wells Fargo Securities, LLC, as of June 30, 2012. The shareholders' equity at risk did not exceed 10% for any of the Company's other counterparties.

The following tables present the components of the Company's repurchase agreements as of June 30, 2012 and December 31, 2011 by the fair value and type of securities pledged as collateral to the repurchase agreements:

June 30, 2012			
Collateral Type	Balance	Weighted Average Rate	Fair Value of Collateral Pledged
Agency RMBS	\$2,162,480	0.40	% \$2,239,357
Agency CMBS and CMBS IOs	468,322	0.81	% 536,268
Non-Agency RMBS	14,575	1.82	% 16,582
Non-Agency CMBS and CMBS IOs	425,241	1.41	% 520,751
Securitization financing bonds	41,306	1.61	% 50,395
	\$3,111,924	0.62	% \$3,363,353

December 31, 2011			
Collateral Type	Balance	Weighted Average Rate	Fair Value of Collateral Pledged
Agency RMBS	\$1,447,508	0.38	% \$1,521,107
Agency CMBS and CMBS IOs	290,362	0.59	% 329,612
Non-Agency RMBS	12,195	1.85	% 13,597
Non-Agency CMBS and CMBS IOs	283,266	1.54	% 336,124
Securitization financing bonds	60,462	1.65	% 67,872
	\$2,093,793	0.61	% \$2,268,312

The combined weighted average term to original maturity for the Company's repurchase agreements was 50 days as of June 30, 2012 and 57 days as of December 31, 2011. The following table provides a summary of the original maturity as of June 30, 2012 and December 31, 2011:

Original Maturity	June 30, 2012	December 31, 2011
30 days or less	\$1,076,065	\$180,387
31 to 60 days	1,168,159	880,491
61 to 90 days	536,687	496,509
Greater than 90 days	331,013	536,406
	\$3,111,924	\$2,093,793

Our repurchase agreement counterparties, as set forth in the master repurchase agreement with the counterparty, require us to comply with various customary operating and financial covenants, including, but not limited to, minimum net worth, maximum declines in net worth in a given period, and maximum leverage requirements as well as maintaining our REIT status. In addition, some of the agreements contain cross default features, whereby default under an agreement with one lender simultaneously causes default under agreements with other lenders. To the extent that we fail to comply with the covenants contained in our financing agreements or are otherwise found to be in default under the terms of such agreements, the counterparty has the right to accelerate amounts due under the master repurchase agreement. The Company was in compliance with all covenants as of June 30, 2012.

NOTE 9 – NON-RECOURSE COLLATERIZED FINANCING

The following table summarizes information about the Company's non-recourse collateralized financing for the periods indicated:

	June 30, 2012			
	Interest Rate	Weighted Average Life Remaining (in years)	Balance Outstanding	Value of Collateral
Securitization financing:				
Secured by non-Agency CMBS	6.2% fixed	2.1	\$15,000	\$16,088
Secured by single-family mortgage loans	1-month LIBOR plus 0.30%	3.2	17,145	17,857
Unamortized net bond premium and deferred costs			(584)	) n/a
			\$31,561	\$33,945
	December 31, 2011			
	Interest Rate	Weighted Average Life Remaining (in years)	Balance Outstanding	Value of Collateral
Securitization financing:				
Secured by non-Agency CMBS	6.2% fixed	2.1	\$15,000	\$16,388
Secured by single-family mortgage loans	1-month LIBOR plus 0.30%	3.2	18,928	19,843
TALF financing: ⁽¹⁾				
Secured by non-Agency CMBS	2.7% fixed	1.2	37,672	49,087
Unamortized net bond premium and deferred costs			(705)	) n/a
			\$70,895	\$85,318

⁽¹⁾ Financing provided by the Federal Reserve Bank of New York under its Term Asset-Backed Securities Loan Facility ("TALF"). The balance as of December 31, 2011 was paid off during the first quarter of 2012.

NOTE 10 – FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and also requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability. ASC Topic 820 established a valuation hierarchy of three levels as follows:

Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities as of the measurement date.

•

Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs are either directly observable or indirectly observable through correlation with market data at the measurement date and for the duration of the instrument’s anticipated life. The Company’s fair valued assets and liabilities that are generally included in this category are Agency

MBS, certain non-Agency MBS, and derivatives.

Level 3 – Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management’s best estimate of how market participants would price the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model. The Company’s fair valued assets and liabilities that are generally included in this category are certain non-Agency MBS.

The following table presents the fair value of the Company’s assets and liabilities measured at fair value on a recurring basis as of June 30, 2012, segregated by the hierarchy level of the fair value estimate:

	Fair Value	Fair Value Measurements		
		Level 1	Level 2	Level 3
Assets:				
Agency MBS	\$2,979,039	\$—	\$2,979,039	\$—
Non-Agency MBS:				
CMBS (including CMBS IO)	540,858	—	436,343	104,515
RMBS	18,108	—	5,451	12,657
Other investments	25	—	—	25
Total assets carried at fair value	\$3,538,030	\$—	\$3,420,833	\$117,197
Liabilities:				
Derivative liabilities	\$39,267	\$—	\$39,267	\$—
Total liabilities carried at fair value	\$39,267	\$—	\$39,267	\$—

The Company’s Agency MBS, as well a portion of its non-Agency CMBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple dealer quotes and thus are considered Level 2 fair value measurements.

The Company’s remaining non-Agency CMBS and non-Agency RMBS are comprised of securities for which there are not substantially similar securities that trade frequently. As such, the Company determines the fair value of those securities by discounting the estimated future cash flows derived from cash flow models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant inputs into those pricing models are Level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security’s credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Significant increases (decreases) in any of these inputs in isolation would result in a significantly lower (higher) fair value measurement. A change in the assumption used for the probability of default may be accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

The table below presents information about the significant unobservable inputs used in the fair value measurement for the Company's Level 3 non-Agency RMBS and CMBS during the three and six months ended June 30, 2012:

	Quantitative Information about Level 3 Fair Value Measurements ⁽¹⁾					
	Prepayment Speed	Default Rate	Severity	Discount Rate		
Non-Agency CMBS	19 CPY	2.4	% 33.5	% 4.6		%
Non-Agency RMBS	5	CPR 0.5	% 9.8	% 5.8		%

(1)Data presented are weighted averages.

The following tables present the activity of the instruments fair valued at Level 3 for the three and six months ended June 30, 2012:

	For the Three Months Ended June 30, 2012			
	Level 3 Fair Values			Total assets
	Non-Agency CMBS	Non-Agency RMBS	Other	
Balance as of March 31, 2012	\$115,830	\$8,627	\$25	\$124,482
Purchases	—	7,500	—	7,500
Transfers out to Level 2	(4,670	) —	—	(4,670
Total unrealized losses:				
Included in other comprehensive income	(1,487	) 48	—	(1,439
Principal payments	(5,004	) (3,534	) —	(8,538
Amortization	(154	) 16	—	(138
Balance as of June 30, 2012	\$104,515	\$12,657	\$25	\$117,197

	For the Six Months Ended June 30, 2012			
	Level 3 Fair Values			Total assets
	Non-Agency CMBS	Non-Agency RMBS	Other	
Balance as of December 31, 2011	\$123,703	\$10,296	\$25	\$134,024
Purchases	—	7,500	—	7,500
Transfers out to Level 2	(4,670	) —	—	(4,670
Total unrealized losses:				
Included in other comprehensive income	(2,024	) 78	—	(1,946
Principal payments	(12,215	) (5,241	) —	(17,456
Amortization	(279	) 24	—	(255
Balance as of June 30, 2012	\$104,515	\$12,657	\$25	\$117,197

The Company evaluates the availability and quality of valuation inputs for its Level 3 securities on a monthly basis. When it determines that there are sufficient observable market inputs for the same or similar securities, the securities are transferred to Level 2 at the end of the reporting period in which that determination is made. As shown in the tables above for the three and six months ended June 30, 2012, the Company transferred two of its non-Agency CMBS from Level 3 to Level 2 during the second quarter of 2012. The liquidity for securities similar to these non-Agency CMBS improved such that the Company was able to obtain market discount rates and prepayment speeds which it used in establishing the fair value of these two non-Agency CMBS. The change in the fair value from March 31, 2012 to June 30, 2012 of these non-Agency CMBS transferred out of Level 3 and into Level 2 was immaterial.

The following table presents the recorded basis and estimated fair values of the Company's financial instruments as of June 30, 2012 and December 31, 2011:

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	June 30, 2012		December 31, 2011	
	Recorded Basis	Fair Value	Recorded Basis	Fair Value
Assets:				
Agency MBS	\$2,979,039	\$2,979,039	\$1,965,159	\$1,965,159
Non-Agency CMBS	540,858	540,858	405,826	405,826
Non-Agency RMBS	18,108	18,108	15,270	15,270
Securitized mortgage loans, net	89,225	81,932	113,703	101,116
Other investments	933	990	1,018	892
Liabilities:				
Repurchase agreements	\$3,111,924	\$3,111,924	\$2,093,793	\$2,093,793
Non-recourse collateralized financing	31,561	30,689	70,895	69,752
Derivative liabilities	39,267	39,267	27,997	27,997

There were no assets or liabilities which were measured at fair value on a non-recurring basis as of June 30, 2012 or December 31, 2011.

The Company held investments in 330 Agency MBS and 59 non-Agency MBS as of June 30, 2012 compared to 266 Agency MBS and 44 non-Agency MBS as of December 31, 2011. The following table presents certain information for those Agency MBS and non-Agency MBS that were in an unrealized loss position as of June 30, 2012 and December 31, 2011:

(\$ in thousands)	June 30, 2012			December 31, 2011		
	Fair Value	Unrealized Loss	# of Securities	Fair Value	Unrealized Loss	# of Securities
Unrealized loss position for:						
Less than one year:						
Agency MBS	\$271,727	\$(1,655)	) 33	\$680,101	\$(6,765)	) 54
Non-Agency MBS	20,369	(1,338)	) 7	153,974	(5,075)	) 6
One year or more:						
Agency MBS	379,030	(5,580)	) 37	160,544	(1,684)	) 27
Non-Agency MBS	8,198	(801)	) 8	2,993	(379)	) 7
	\$679,324	\$(9,374)	) 85	\$997,612	\$(13,903)	) 94

Because the principal and interest related to Agency MBS are guaranteed by the government-sponsored entities Fannie Mae and Freddie Mac who have the implicit guarantee of the U.S. government, the Company does not consider any of the unrealized losses on its Agency MBS to be credit related. Although the unrealized losses are not credit related, the Company assesses its ability and intent to hold any Agency MBS with an unrealized loss until the recovery in its value. This assessment is based on the amount of the unrealized loss and significance of the related investment as well as the Company's current leverage and anticipated liquidity. Based on this analysis, the Company has determined that the unrealized losses on its Agency MBS as of June 30, 2012 are temporary.

The Company reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an other-than-temporary impairment. The evaluation includes a review of the credit ratings of these MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows which include projected losses. The Company performed this evaluation for the non-Agency MBS in an unrealized loss position as of June 30, 2012 and has determined that there have not been any adverse changes in the timing or amount of estimated future cash flows that necessitate a recognition of other-than-temporary impairment amounts as of June 30, 2012.

NOTE 11 – SHAREHOLDERS' EQUITY

Common Stock

The following table presents a summary of the changes in the number of common shares outstanding for the periods indicated:

	Six Months Ended	
	June 30,	
	2012	2011
Balance at beginning of period	40,382,530	30,342,897
Common stock issued under ATM program	402,494	409,237
Common stock issued under DRIP	6,947	—
Common stock issued via public offering	13,332,748	9,200,000
Common stock issued or redeemed under Stock and Incentive Plans	241,663	391,025
Balance at end of period	54,366,382	40,343,159

The Company has a continuous equity placement program (also known as an "at the market" program, or "ATM") whereby the Company may offer and sell through its sales agent, JMP Securities LLC, up to 8,000,000 shares of its common stock. During the six months ended June 30, 2012, the Company received proceeds of \$3,721, net of \$57 in broker sales commission, for 402,494 shares of common stock sold under this program at an average price of \$9.39. The Company did not issue any common stock under this program during the three months ended June 30, 2012.

The Company has a Dividend Reinvestment and Share Purchase Plan ("DRIP") which allows registered shareholders to automatically reinvest some or all of their quarterly dividends in shares of the Company's stock and provides an opportunity for investors to purchase shares of the Company's stock, potentially at a discount to the prevailing market price. The Company declared a second quarter common stock dividend of \$0.29 per share payable on July 31, 2012 to shareholders of record as of July 6, 2012; however there is no dividend reinvestment discount for second quarter dividends reinvested through the DRIP.

During the six months ended June 30, 2012, the Company closed a secondary offering of 13,332,748 shares of its common stock which includes 832,487 shares issued pursuant to an option to purchase additional shares that was exercised by the underwriters, at a public offering price of \$9.12 per share for total net proceeds of approximately \$119,992 after deduction of underwriters' compensation and expenses.

Incentive Plans. Pursuant to the Company's 2009 Stock and Incentive Plan, the Company may grant stock-based compensation to eligible employees, directors or consultants or advisers to the Company, including stock awards, stock options, stock appreciation rights, dividend equivalent rights, performance shares, and restricted stock units. Of the 2,500,000 shares of common stock authorized for issuance under this plan, 1,805,276 shares remain available for issuance as of June 30, 2012.

The following table presents a rollforward of the restricted stock activity for the periods presented:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Restricted stock at beginning of period	457,034	320,500	365,506	25,000
Restricted stock granted	20,000	20,000	220,821	323,000
Restricted stock vested	(22,917	) (10,000	) (132,210	) (17,500

Restricted stock outstanding at end of period	454,117	330,500	454,117	330,500
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As of June 30, 2012, the fair value of the Company's outstanding restricted stock remaining to be amortized into compensation expense is \$3,894.

As of June 30, 2012, the Company has 52,500 SARs outstanding, all of which are vested and exercisable at a weighted average price of \$6.85. The weighted average remaining contractual term on these outstanding SARs as of June 30, 2012 is 13 months, and 25,000 of the outstanding SARs are set to expire if they are not exercised on or before December 31, 2012. No SARs were granted, forfeited, or exercised during the three and six months ended June 30, 2012 or June 30, 2011. As of June 30, 2012 and December 31, 2011, the fair value of the Company's outstanding SARs of \$164 and \$77, respectively, are recorded as liabilities on its consolidated balance sheet for the respective periods.

Total stock-based compensation expense recognized by the Company for the three and six months ended June 30, 2012 was \$468 and \$920, respectively, compared to \$258 and \$353, respectively, for the three and six months ended June 30, 2011.

Additional Paid-In Capital

The following table presents a rollforward of the Company's changes in additional paid-in capital for the six months ended June 30, 2012:

	Additional Paid-In Capital
Balance as of January 1, 2012	\$634,683
Common stock issuances:	
DRIP issuances	66
ATM issuances	3,674
Secondary offering	119,859
Incentive plans	192
Amortization of restricted stock	812
Capitalized expenses	(119)
Balance as of June 30, 2012	\$759,167

Accumulated Other Comprehensive Income

Accumulated other comprehensive income as of June 30, 2012 and December 31, 2011 is comprised of the following items:

	June 30, 2012	December 31, 2011
Available for sale investments:		
Unrealized gains	\$65,279	\$36,091
Unrealized losses	(7,325)	(13,902)
	57,954	22,189
Hedging instruments:		
Unrealized losses	(36,449)	(25,444)
	(36,449)	(25,444)
Accumulated other comprehensive income (loss)	\$21,505	\$(3,255)

Due to the Company's REIT status, the items comprising other comprehensive income do not have related tax effects.

NOTE 12 – COMMITMENTS AND CONTINGENCIES

The Company and its subsidiaries are parties to various legal proceedings, including those described below. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings, including those described below, will not have a material effect on the Company's consolidated financial condition or liquidity. However, the resolution of any of the proceedings described below could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

One of the Company's subsidiaries, GLS Capital, Inc. ("GLS"), and the County of Allegheny, Pennsylvania ("Allegheny County") are defendants in a class action lawsuit filed in 1997 in the Court of Common Pleas of Allegheny County, Pennsylvania (the "Court"). Between 1995 and 1997, GLS purchased from Allegheny County delinquent property tax receivables for properties located in the county. The plaintiffs in this matter have alleged that GLS improperly recovered or sought recovery for certain fees, costs, interest, and attorneys' fees and expenses in connection with GLS' collection of the property tax receivables. The Court granted class action status in this matter in August 2007. In February 2011, as a result of motions filed by GLS, the Court refined the class to include only owners of real estate in Allegheny County who paid an attorneys' fee between 1996 and 2003 in connection with the forced collection of delinquent property tax receivables by GLS (generally through the initiation of a foreclosure action). As a result, the Court dismissed certain claims against GLS and narrowed the issues being litigated to whether attorneys' fees and related expenses charged by GLS in connection with the collection of the receivables were reasonable. Such attorneys' fees and related expenses were assessed by GLS in its collection efforts pursuant to prevailing Allegheny County ordinance. On April 23, 2012, as a result of a petition to discontinue filed by the plaintiffs, the Court dismissed the remaining claims against GLS. The claims made by plaintiff that can be appealed include the legality of charging and recovering attorneys' fees and lien revival and filing costs from the class members. Plaintiff has not yet appealed the Court's ruling but the Company expects them to do so. Plaintiffs have not enumerated their damages in this matter.

The Company, GLS, and Allegheny County are named defendants in a putative class action lawsuit filed in June 2012 in the Court of Common Pleas of Allegheny County, Pennsylvania. The proposed class in this action consists of owners of real estate in Allegheny County whose property is or has been subject to a tax lien filed by Allegheny County that Allegheny County either retained or sold to GLS and who were billed by Allegheny County or GLS for attorneys' fees, interest, or prothonotary fees and who sustained economic damages on and after August 14, 2003, in connection with attempts to collect delinquent real estate taxes. The putative class allegations are that Allegheny County, GLS, and the Company violated the class's constitutional due process rights in connection with delinquent tax collection efforts. There are also allegations that amounts recovered from the class by GLS and / or Allegheny County are an unconstitutional taking of private property. The claims against the Company are solely based upon its ownership of GLS. The complaint requests that the Court order GLS to account for the amounts alleged to have been collected in violation of the putative class members' rights and create a constructive trust for the return of such amounts to members of the purported class. The same class previously filed substantially the same lawsuit in 2004 against GLS and Allegheny County, and GLS's Motion for Summary Judgment is pending in that action. The Company believes the claims are without merit and intends to defend against them vigorously.

The Company and DCI Commercial, Inc. ("DCI"), a former affiliate of the Company and formerly known as Dynex Commercial, Inc., are appellees (or respondents) in the matter of Basic Capital Management, Inc. et al. (collectively, "BCM" or the "Plaintiffs") versus DCI et al. currently pending in the Fifth Court of Appeals in Dallas. The matter was initially filed in the state court in Dallas County, Texas in April 1999 against DCI, and in March 2000, BCM amended the complaint and added the Company as a defendant. The appeal seeks to overturn a judgment rendered by the trial court in the favor of the Company and DCI. Specifically, Plaintiffs are seeking reversal of the trial court's

judgment and rendition of judgment against the Company for alleged breach of loan agreements for tenant improvements in the amount of \$250. They also seek reversal of the trial court's judgment and rendition of judgment against DCI in favor of BCM under two mutually exclusive damage models, for \$2,200 and \$25,600, respectively, related to the alleged breach by DCI of a \$160,000 "master" loan commitment. Plaintiffs also seek reversal and rendition of a judgment in their favor for attorneys' fees in the amount of \$2,100. Alternatively, Plaintiffs seek a new trial. Even if Plaintiffs were to be successful on appeal, management does not believe the Company would be obligated for any amounts awarded against DCI.

NOTE 13 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Quarterly Report on Form 10-Q was filed with the SEC and made available to the public and has determined that there have been no significant events or circumstances that qualify as "recognized" subsequent events as defined by ASC Topic 855.

The following events, which occurred subsequent to June 30, 2012 and before the filing of this Quarterly Report on Form 10-Q, qualify as "nonrecognized subsequent events" as defined by ASC Topic 855:

On August 1, 2012, the Company closed an offering of 2,300,000 shares of 8.50% Series A Cumulative Redeemable Preferred Stock, par value of \$0.01 per share and liquidation preference \$25.00 per share, which includes 300,000 shares issued pursuant to an option to purchase additional shares that was exercised by the underwriters. The Company received net proceeds before expenses of \$55,689, including the additional proceeds from the underwriters' overallotment option which was fully exercised. The Company anticipates using the proceeds to acquire additional investments consistent with its investment strategy and for general corporate purposes, which may include, among other things, repayment of maturing obligations, capital expenditures and working capital.

The Company entered into a \$200,000 committed two-year repurchase financing agreement with Wells Fargo Bank, N.A. on August 6, 2012. The Company anticipates financing certain of its CMBS investments with this facility. The facility will bear interest at a variable rate that will reset monthly based on a spread to the 1-month LIBOR rate. The facility contains customary provisions with respect to collateral maintenance requirements and allows Wells Fargo to request additional collateral if the market value of the collateral pledged declines in value. The facility includes financial covenants with respect to minimum net worth, changes in net worth, and leverage levels.

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

The following discussion and analysis should be read in conjunction with our unaudited consolidated financial statements and accompanying notes included in this Quarterly Report on Form 10-Q and our audited Annual Report on Form 10-K for the year ended December 31, 2011. References herein to "Dy nex," the "Company," "we," "us," and "our" include Dy nex Capital, Inc. and its consolidated subsidiaries, unless the context otherwise requires. In addition to current and historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future business, financial condition or results of operations. For a description of certain factors that may have a significant impact on our future business, financial condition or results of operations, see "Forward-Looking Statements" at the end of this discussion and analysis.

EXECUTIVE OVERVIEW

Company Overview

We are an internally managed mortgage real estate investment trust, or mortgage REIT, which invests in mortgage assets on a leveraged basis. Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders through regular quarterly dividends and through capital appreciation.

We were formed in 1987 and commenced operations in 1988. Beginning with our inception through 2000, our operations largely consisted of originating and securitizing various types of loans, principally single-family and commercial mortgage loans and manufactured housing loans. Since 2000, we have been an investor in Agency and non-Agency mortgage-backed securities ("MBS"). Agency MBS consist of residential MBS ("RMBS") and commercial MBS ("CMBS"), which come with a guaranty of payment by the U.S. government or a U.S. government-sponsored entity such as Fannie Mae and Freddie Mac. Non-Agency MBS (also consisting of RMBS and CMBS) have no such guaranty of payment.

The Company's Agency RMBS are comprised primarily of hybrid Agency adjustable-rate mortgage loans ("ARMs") and Agency ARMs. Hybrid Agency ARMs are MBS collateralized by hybrid adjustable-rate mortgage loans which are loans that have a fixed rate of interest for a specified period (typically