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investments:^(a)

Cash yields

2.46

%

2.48

%

2.50

%

2.52

%

2.57

%

2.60

%

2.65

%

2.71

%

Investment premium amortization

(0.67

)

(0.74

)

(1.14

)

(0.99

)

(0.84

)

(0.84

)

(0.79
)

(0.67
)

Adjusted yields

1.79

1.74

1.36

1.53

1.73

1.76

1.86

2.04

Related borrowing rates:^(b)

Repo borrowing rates

0.34

0.38

0.37

0.39

0.41

0.45

0.41

0.37

Fixed swap rates

0.50

0.52

0.59

0.65

0.71

0.75

0.78

0.80

Adjusted borrowing rates

0.49

0.49

0.49

0.53

0.58

0.63

0.56

0.54

Financing spreads on residential mortgage investments

1.30

1.25

0.87

1.00

1.15

1.13

1.30

1.50

CPR

15.16

17.14
25.49
23.12
20.05
19.99
19.14
16.31

Cash yields are based on the cash component of interest income. Investment premium amortization is determined using the interest method which incorporates actual and anticipated future mortgage prepayments. Both are expressed as a percentage calculated on an annualized basis on average amortized cost basis for the indicated periods.

(a) Repo borrowing rates represent average rates on repurchase agreements and similar borrowings, before consideration of related currently-paying interest rate swap agreements.

Fixed swap rates represent the average fixed-rate payments made on currently-paying interest rate swap agreements held for portfolio hedging purposes and exclude differences between LIBOR-based variable-rate payments received on these swaps and repo borrowing rates, as well as the effects of any hedge ineffectiveness. These differences averaged 18 basis points on average currently-paying swap notional amounts outstanding during the first quarter of 2014.

Adjusted borrowing rates reflect repo borrowing rates, fixed swap rates and the above-mentioned differences. All rates presented are expressed as a percentage calculated on an annualized basis for the indicated periods.

First quarter 2014 cash yields declined by two basis points from fourth quarter 2013 cash yields reflecting lower coupon interest rates on mortgage loans underlying the Company's holdings of ARM securities resulting from changes in portfolio composition due to acquisitions and portfolio runoff as well as ARM loan coupon resets. Declines in coupon interest rates because of ARM coupon resets have moderated as an increasing number of these loans approach fully-indexed levels.

Investment premium amortization is primarily driven by changes in mortgage prepayment rates and investment premium levels. As older, lower-basis securities held by the Company prepay, the cost basis of the portfolio (expressed as a ratio of amortized cost basis to unpaid principal balance) has increased over time largely because of higher prices paid in recent periods for acquisitions. During the current quarter the increase was limited to one basis point to 103.27 compared to 17 basis points over the course of 2013. A higher cost basis in the portfolio contributes over time to larger yield adjustments for investment premium amortization.

Mortgage prepayments began moderating the latter part of 2013 as refinancing opportunities began receding after mortgage interest rates rose earlier in the year. A further decline in mortgage prepayment levels during the first quarter of 2014 to two-year lows resulted in a corresponding decline in the yield adjustment necessary for investment premium amortization. This decline was in large part due to higher prevailing mortgage interest rates, as well as seasonal factors. Mortgage prepayment rates will likely be modestly higher during the remainder of 2014 reflecting seasonal factors and an improving housing market. Repo borrowing rates averaged four basis points lower during the

first quarter of 2014 compared to the fourth quarter of 2013 reflecting the current breadth and health of the financing market for Agency Securities. Adjusted for portfolio financing-related and currently-paying interest rate swap agreements, borrowing rates averaged 0.49% during the first quarter of 2014, unchanged from the fourth quarter of 2013 as the benefits of lower repo borrowing rates were offset by a greater percentage of portfolio-financing related interest rate swap agreements moving into current-pay status. See NOTE 7 to the consolidated financial statements for further information regarding the Company's currently-paying and forward-starting swap agreements.

-27-

Index

Reconciliation of Financing Spreads on Residential Mortgage Investments to Total Financing Spreads

Financing spreads on residential mortgage investments differs from total financing spreads, an all-inclusive GAAP measure, that is based on all interest-earning assets and all interest-paying liabilities. The Company believes that presenting financing spreads on residential mortgage investments provides useful information for evaluating portfolio performance. The following table reconciles this measure for the indicated periods:

	2014 Q1	2013 Q4	Q3	Q2	Q1	2012 Q4	Q3	Q2
Financing spreads on residential mortgage investments	1.30 %	1.25 %	0.87 %	1.00 %	1.15 %	1.13 %	1.30 %	1.50 %
Impact of yields on other interest-earning assets*	(0.04)	(0.03)	(0.02)	(0.05)	(0.05)	(0.07)	(0.05)	(0.06)
Impact of borrowing rates on unsecured borrowings and interest-paying liabilities*	(0.07)	(0.07)	(0.06)	(0.06)	(0.06)	(0.06)	(0.06)	(0.07)
Total financing spreads	1.19	1.15	0.79	0.89	1.04	1.00	1.19	1.37

Other interest-earning assets consist of overnight investments and cash collateral receivable from interest rate swap * counterparties. Other interest-paying liabilities consist of long-term unsecured borrowings (at an average borrowing rate of 8.49%) that the Company considers a component of its long-term investment capital and cash collateral payable to interest rate swap counterparties.

Utilization of Long-term Investment Capital and Potential Liquidity

Capstead's investment strategy is to manage a conservatively leveraged portfolio of ARM Agency Securities that can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. Borrowings under repurchase arrangements generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Consequently, potential liquidity inherent in the Company's unencumbered residential mortgage investments is as important as the actual level of cash and cash equivalents carried on the balance sheet. Potential liquidity is affected by, among other things, current portfolio leverage levels; changes in market value of assets pledged and interest rate swap agreements held for hedging purposes as determined by lending and swap counterparties; principal prepayments; collateral requirements of lenders and swap counterparties; and general conditions in the commercial banking and mortgage finance industries. Future levels of portfolio leverage will be dependent upon many factors, including the size and composition of the Company's investment portfolio (see "Liquidity and Capital Resources").

Index

Capstead's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of March 31, 2014 in comparison with December 31, 2013 (in thousands):

	Investments (a)	Related Borrowings	Capital Employed	Potential Liquidity (b)	Portfolio Leverage
Balances as of March 31, 2014:					
Residential mortgage investment portfolio	\$13,529,211	\$12,590,255	\$938,956	\$300,912	
Cash collateral receivable from swap counterparties, net ^(c)			21,764	—	
Other assets, net of other liabilities			517,869	486,293	
			\$1,478,589	\$787,205	8.52:1
Balances as of December 31, 2013	\$13,475,874	\$12,482,900	\$1,465,783	\$770,639	8.52:1

(a) Investments are stated at balance sheet carrying amounts, which generally reflect estimated fair value as of the indicated dates.

Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted repurchase (b) arrangements considering management's estimate of the fair value of related collateral as of the indicated dates adjusted for other sources of liquidity such as cash and cash equivalents.

(c) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties, if applicable, and the fair value of interest rate swap positions as of the indicated date.

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (remitted to the Company 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and therefore increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to address challenging market conditions and limits exposure to any individual counterparty.

At March 31, 2014 portfolio leverage was unchanged from year-end at 8.52 to one while the portfolio, long-term investment capital and potential liquidity increased modestly during this period. Management believes current portfolio leverage levels represent an appropriate and prudent use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

Index

RESULTS OF OPERATIONS

	Quarter Ended March 31			
	2014		2013	
Income statement data: (in thousands, except per share data)				
Interest income on residential mortgage investments (before investment premium amortization)	\$81,733		\$86,867	
Investment premium amortization	(22,288)		(28,399)	
Related interest expense	(15,407)		(18,468)	
	44,038		40,000	
Other interest income (expense) *	(2,061)		(2,010)	
	41,977		37,990	
Other revenue (expense):				
Salaries and benefits	(1,132)		(1,001)	
Annual incentive compensation	(540)		(554)	
Long-term incentive compensation	(626)		(406)	
Other general and administrative expense	(1,203)		(1,081)	
Miscellaneous other revenue (expense)	(85)		(30)	
	(3,586)		(3,072)	
Net income	\$38,391		\$34,918	
Net income per diluted common share	\$0.37		\$0.31	
Average diluted shares outstanding	95,538		95,450	
Key operating statistics: (dollars in millions)				
Average yields:				
Residential mortgage investments:				
Cash yields	2.46	%	2.57	%
Investment premium amortization	(0.67)		(0.84)	
Adjusted yields	1.79		1.73	
Other interest-earning assets	0.06		0.11	
Total average yields	1.75		1.68	
Average borrowing rates:				
Repurchase arrangements and similar borrowings:				
Repo borrowing rates	0.34		0.41	
Fixed swap rates	0.50		0.71	
Adjusted borrowing rates	0.49		0.58	
Unsecured borrowings	8.49		8.49	
Total average borrowing rates	0.56		0.64	
Total average financing spreads	1.19		1.04	
Average financing spreads on residential mortgage investments	1.30		1.15	
Average net yield on total interest-earning assets	1.23		1.09	
Average CPR	15.16		20.05	
Average balance information:				
Residential mortgage investments (cost basis)	\$13,254		\$13,543	
Other interest-earning assets	383		428	
Repurchase arrangements and similar borrowings	12,466		12,769	
Currently-paying swap agreements (notional amounts)	5,686		4,293	
Unsecured borrowings (included in long-term investment capital)	100		103	
Long-term investment capital ("LTIC")	1,485		1,605	
Portfolio leverage	8.39:1		7.96:1	

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Operating costs as a percentage of average LTIC	0.96	%	0.77	%
Return on average LTIC	11.07		9.36	
Return on average common equity capital	11.70		9.14	

* Consists principally of interest on unsecured borrowings and is presented net of earnings of related statutory trusts.
These affiliates were dissolved in December 2013.

-30-

Index

Capstead reported net income of \$38 million or \$0.37 per diluted common share for the first quarter of 2014 compared to \$35 million or \$0.31 per diluted common share for the first quarter of 2013.

Financing spreads on residential mortgage investments averaged 1.30% for the first quarter of 2014, compared to 1.15% for the first quarter of 2013. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on residential mortgage investments, net of repo borrowing rates after adjusting for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 28 for a reconciliation of these GAAP and non-GAAP financial measures. Higher financing spreads reflect lower investment premium amortization as a result of a 24% decline in mortgage prepayment rates offset by the effects of a modestly lower average portfolio outstanding and lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates resetting lower to more current rates as well as lower coupon interest rates on acquisitions. Average borrowing rates were considerably lower than in the first quarter of 2013 reflecting the benefits of lower market rates for repo financing and older, higher-rate interest rate swap agreements used for hedging purposes being replaced with lower-rate swap agreements since the beginning of last year.

Yields on residential mortgage securities averaged 1.79% during the quarter ended March 31, 2014, compared to 1.73% for the same period in 2013. Cash yields averaged 2.46% during the quarter ended March 31, 2014; which was 11 basis points lower than cash yields reported for the same period in 2013. Investment premium amortization totaled \$22 million for the quarter ended March 31, 2014, representing a yield adjustment of 67 basis points, compared to amortization of \$28 million or 84 basis points for the same period in 2013. Of the 17 basis point decrease in investment premium amortization, approximately 19 basis points was attributable to lower levels of portfolio runoff due to lower levels of mortgage prepayments, while the offsetting two basis points was primarily attributable to increases in the cost basis of the portfolio. See page 27 for further discussion of the effects of the current market environment on mortgage prepayment levels.

After adjusting for interest rate hedging transactions, borrowing rates averaged 0.49% during the quarter ended March 31, 2014, a decrease of nine basis points from the same period in 2013. Repo borrowing rates averaged 0.34% during the first quarter of 2014, seven basis points lower than rates reported for the same period in 2013, reflecting increasingly healthy repo financing market conditions, including less competition for borrowings as a result of significant declines in portfolio holdings experienced by the Company's mortgage REIT peers in 2013. Rates on \$5.69 billion of the Company's average borrowings during the quarter ended March 31, 2014 were largely fixed through the use of interest rate swap agreements. The corresponding amount was \$4.29 billion for the same period in 2013. Fixed-rate payment requirements on the Company's currently-paying swap positions (excluding adjustments for spreads between variable rates on the swap agreements and repo borrowing rates and the effects of measured hedge ineffectiveness) averaged 0.50% for the first quarter of 2014, which was 21 basis points lower than rates reported for the same period in 2013, reflecting the expiration of older, higher-rate swap agreements over the last 15 months which were replaced with lower-rate swap agreements. Some of the benefits of lower repo borrowing rates and lower fixed-rate payment requirements were offset by a greater percentage of portfolio-financing related interest rate swap agreements moving into current-pay status.

Operating costs (salaries and benefits, incentive compensation and other general and administrative expense) as a percentage of long-term investment capital averaged 0.96% for the first quarter of 2014, which was 19 basis points higher than reported for the same period in 2013. The increase is attributable to higher costs in addition to the effects of lower average long-term investment capital on the ratio. See NOTE 11 to the accompanying consolidated financial statements for additional information regarding the Company's compensation programs.

Index

LIQUIDITY AND CAPITAL RESOURCES

Capstead's primary sources of funds are borrowings under repurchase arrangements and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity inherent in its unencumbered residential mortgage investments is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under "Utilization of Long-term Investment Capital and Potential Liquidity" on page 29 illustrates management's estimate of additional funds potentially available to the Company as of March 31, 2014 and the accompanying discussion provides insight into the Company's perspective on the appropriate level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments, common share repurchases when considered appropriate, repayments on borrowings and the payment of cash dividends as required for the Company's continued qualification as a REIT. It is the Company's policy to remain strongly capitalized and conservatively leveraged.

Capstead generally pledges its residential mortgage investments as collateral under repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. As of March 31, 2014, the Company had uncommitted repurchase facilities with a variety of lending counterparties to finance its portfolio, subject to certain conditions, and had borrowings outstanding with 22 of these counterparties. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Borrowings under repurchase arrangements totaled \$12.59 billion at March 31, 2014, primarily with original maturities of 30 days. Borrowings under repurchase arrangements began the year at \$12.48 billion and averaged \$12.47 billion during the first quarter of 2014. Average borrowings during the quarter can differ from quarter-end balances for a number of reasons including portfolio growth or contraction as well as differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to higher interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms that are designated as cash flow hedges of a like amount of borrowings under repurchase arrangements. At March 31, 2014, portfolio financing-related swap agreements totaling \$7.20 billion notional amount with average contract expirations of 17 months, consisting of (a) \$5.70 billion notional amount in currently-paying swap agreements requiring the payment of fixed rates of interest averaging 0.50% for average remaining interest-payment terms of 15 months and (b) \$1.50 billion notional amount in forward-starting swap agreements that will begin requiring fixed rate interest payments averaging 0.49% for two-year periods that commence on various dates between April 2014 and July 2014, with average contract expirations of 25 months. Relative to the floating rate terms of the Company's \$100 million in unsecured borrowings that begin at various dates between October 2015 and September 2016, the Company entered into forward-starting swap agreements to effectively lock in fixed rates of interest averaging 7.56% for the final 20 years of these borrowings that mature in 2035 and 2036. The Company intends to continue to utilize suitable derivative financial instruments such as interest rate swap agreements to manage interest rate risk.

Index

In late 2012 Capstead implemented a \$100 million common share repurchase program and suspended its common share continuous offering program until further notice. Purchases made pursuant to the common share repurchase program can be made in the open market or through privately negotiated transactions from time to time as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any repurchases are determined by the Company in its discretion and are subject to economic and market conditions, applicable legal requirements and other factors. Pursuant to this authorization, in late 2012 repurchases totaled 3.0 million common shares at an average cost of \$11.80 per share for \$35 million. An additional 638,000 shares were repurchased in early January 2013 at an average cost of \$11.43 per share for \$7 million, leaving \$58 million of the authorization available for future repurchases. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. Upon suspension of the repurchase program, issuances of common shares under the continuous offering program or by other means may resume subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

In May 2013 Capstead completed a public offering of 6.8 million shares (\$170 million face amount) of its 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, using the \$164 million in proceeds, net of underwriter fees and other costs, together with \$43 million of cash on hand to fund the June 2013 redemption of the Company's Series A and B perpetual preferred shares. The Series E shares are redeemable at the Company's option for \$25.00 per share, plus any accumulated and unpaid dividends, on or after May 13, 2018. In late 2013 the Company began issuing additional Series E preferred shares through an at-the-market continuous offering program. During the quarter ended March 31, 2014, the Company issued 56,000 Series E preferred shares at an average price of \$23.83, net of expenses, and has continued issuing Series E preferred shares subsequent to quarter-end. Modest additional amounts of Series E preferred capital may be raised in the future under this program subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

Interest Rate Risk

Because Capstead's residential mortgage investments consist almost entirely of Agency Securities, which are considered to have limited, if any, credit risk, interest rate risk is the primary market risk faced by the Company. Interest rate risk is highly sensitive to a number of factors, including economic conditions, government fiscal policy, central bank monetary policy and banking regulation. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration, fixed-rate assets. These declines can be recovered in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment. This strategy positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates.

To further mitigate Capstead's exposure to higher short-term interest rates, the Company uses currently-paying and forward-starting interest rate swap agreements that typically require interest payments for two-year terms in order to lengthen the effective duration of its borrowings to more closely match the duration of its investments. After consideration of all swap positions entered into as of quarter-end to hedge changes in short-term interest rates, the Company's residential mortgage investments and related borrowings under repurchase arrangements had estimated durations at March 31, 2014 of 11½ and 9½ months, respectively, for a net duration gap of approximately two months. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repurchase arrangements if available at attractive terms.

Index

RISK FACTORS

An investment in securities issued by Capstead involves various risks. An investor should carefully consider the following risk factors in conjunction with the other information contained in this document before purchasing the Company's securities. The risks discussed herein can adversely affect the Company's business, liquidity, operating results, financial condition and future prospects, causing the market price of the Company's securities to decline, which could cause an investor to lose all or part of his/her investment. The risk factors described below are not the only risks that may affect the Company. Additional risks and uncertainties not presently known to the Company also may adversely affect its business, liquidity, operating results, prospects and financial condition.

Risks Related to Capstead's Business

Monetary policy actions by the Federal Reserve could adversely affect Capstead's liquidity, financial condition and earnings. Over the last six years the Federal Reserve has employed a number of new policy initiatives, most notably the purchase of U.S. Treasury securities and Agency Securities. This expansion of the Federal Reserve's balance sheet is often referred to as quantitative easing or QE. The policy goals of the QE initiatives have been to support the GSEs and the housing markets, and otherwise improve economic and labor market conditions by exerting downward pressure on longer term interest rates, including mortgage interest rates.

Under the current QE initiative that began in September 2012 (referred to as QE3), the Federal Reserve had been purchasing \$45 billion a month in long-term Treasury securities and \$40 billion a month in fixed-rate Agency Securities, as well as replacing run off of existing holdings of fixed-rate Agency Securities. In May 2013 the markets began interpreting comments by members of the Federal Reserve's Federal Open Market Committee to mean that purchases under QE3 would begin to be reduced sometime in 2013. The Federal Reserve then articulated that the so-called "tapering" of purchases could begin in September 2013. Citing mixed economic reports and the potential for further fiscal discord in Washington, the Federal Reserve did not begin tapering in September; however in December 2013 it announced that beginning in January 2014 it was reducing purchases of Treasuries and Agency Securities by \$5 billion each. At each successive meeting thus far in 2014 further tapering of \$5 billion each was announced such that for May 2014 the Federal Reserve plans on purchasing \$25 billion in Treasury Securities and \$20 billion in Agency Securities, while continuing to replace portfolio runoff. The Federal Reserve has indicated that the pace of tapering can be expected to continue, contingent upon its outlook for the labor market and inflation as well as its assessment of the efficacy and costs of such purchases.

In general, QE elevated pricing for Agency Securities resulting in declining yields on new purchases and lower mortgage interest rates, resulting in higher mortgage prepayment rates. The Company's net interest margins, and therefore earnings, have been adversely affected over time as its existing portfolio is replaced with higher cost, lower-yielding securities. See discussion below regarding the negative effects of higher mortgage prepayment levels.

Because of expectations for near-term tapering of QE3, in May and June 2013 the markets experienced an abrupt transition to higher long-term interest rates, which had a substantial negative effect on pricing for longer-duration ARM and fixed-rate Agency Securities in particular, and to a lesser extent, on the Company's portfolio of seasoned, short-duration ARM Agency Securities. This initially had a negative effect on the Company's liquidity and book value per common share, even as mortgage prepayment rates eventually receded as opportunities for mortgagors to refinance into lower-rate mortgages dissipated. The actual pace of tapering could result in additional negative effects. In addition, should the Federal Reserve decide to eventually reduce its holdings of fixed-rate Agency Securities through asset sales, the pricing for all Agency Securities could decline, which could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described below.

Index

Potential changes in the relationship between the federal government and the GSEs could adversely affect Capstead's liquidity, financial condition and earnings. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest on these securities are guaranteed by the GSEs, or by Ginnie Mae, an agency of the federal government. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. The high actual or perceived credit quality of Agency Securities allows the Company to finance its portfolio using repurchase arrangements with favorable interest rate terms and margin requirements that otherwise would not be available. As a result of deteriorating housing market conditions that began in 2007, the GSEs incurred substantial losses due to high levels of mortgagor defaults and in 2008 the Federal Housing Finance Agency placed the GSEs into conservatorship, allowing it to operate the GSEs without forcing them to liquidate. Additionally, the federal government, through the U.S. Treasury and the Federal Reserve, undertook other actions to provide financial support to these entities and the housing market including the acquisition of large holdings of Agency Securities. These and other steps taken by the federal government were designed to support market stability and mortgage availability at favorable rates in part by providing additional confidence to investors in Agency Securities.

It is anticipated that over the next several years U.S. policy makers will reach a consensus on what the long-term role of the federal government in general, and the GSEs in particular, will have in the housing markets. In this regard there have been numerous proposals put forth by members of both Houses of Congress, the Treasury Department and regulators regarding GSE reform. The actual or perceived credit quality of Agency Securities could be adversely affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Ginnie Mae, the GSEs or their successors could adversely affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of Agency Securities remains viable, which could adversely affect earnings and book value per common share.

Failure of the federal government to periodically increase the U.S. Treasury's borrowing capacity while reducing future federal budget deficits could adversely impact Capstead's liquidity, financial condition and earnings. The increasing amount of outstanding federal debt relative to the size of the U.S. economy, particularly in light of projected growth in federal government spending and resulting federal budget deficits, have increased the possibility of further credit rating agency actions to downgrade the federal government's credit rating. This could eventually lead to a decline in the market's perception of the creditworthiness of the federal government. Because market participants rely on the federal government's continued support of the GSEs, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings of Agency Securities could be adversely affected. In addition, these circumstances could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of borrowings under repurchase arrangements which could adversely impact the Company's liquidity, earnings and book value per common share, as more fully described below.

Legislative and regulatory actions could adversely affect the availability and/or terms and conditions of borrowings under repurchase arrangements and consequently, the Company's liquidity, financial condition and earnings. In July 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") in order to restrict certain business practices of systemically significant participants in the financial markets, which include many of the Company's lending counterparties. Additionally, changes in regulatory capital requirements and other leverage constraints are being implemented worldwide. It remains unclear how significant of an impact Dodd Frank and changes in regulatory capital requirements will have on the financial markets in general and on the Company's strategy of holding an appropriately hedged, leveraged portfolio of Agency Securities. However, it is possible that the availability and/or terms and conditions of borrowings under repurchase arrangements and related derivative financial instruments held for hedging purposes could be adversely affected which could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described below.

Index

Government-supported mortgagor relief programs could adversely affect Capstead's liquidity, financial condition and earnings. U.S. policy makers have established programs designed to provide qualified homeowners with assistance in avoiding foreclosure or in qualifying for the refinancing of their existing mortgages, which typically entails the pay off of existing mortgages with any losses absorbed by the GSEs. One of these programs, the Home Affordable Refinance Program ("HARP"), has been revised with the intent of increasing its availability to homeowners who are current on their mortgage payments but whose homes have lost significant value making it difficult to qualify for a new mortgage. A significant expansion of these mortgagor relief programs, as well as any future legislative or regulatory actions, could significantly increase mortgage prepayments which could reduce the expected life of the Company's residential mortgage investments; therefore, actual yields the Company realizes on these investments could be lower due to faster amortization of investment premiums which could adversely affect earnings. A significant expansion of these programs also could adversely affect book value per common share because of the elimination of any unrealized gains on that portion of the portfolio that prepays. Additionally, heightened prepayment exposure due to the real or perceived potential for government intervention could adversely affect pricing for Agency Securities in general and, as a result, liquidity and book value per common share could be adversely affected due to declines in the fair value of the Company's remaining portfolio.

An increase in prepayments may adversely affect Capstead's liquidity, financial condition and earnings. When short- and long-term interest rates are at nearly the same levels (i.e., a "flat yield curve" environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's portfolio of residential mortgage investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums, which could adversely affect earnings. High levels of mortgage prepayments can also lead to larger than anticipated demands on the Company's liquidity from its lending counterparties, as more fully described below. Additionally, periods of high prepayments can adversely affect pricing for Agency Securities in general and, as a result, book value per common share can be adversely affected due to declines in the fair value of the Company's remaining portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

Changes in interest rates, whether increases or decreases, may adversely affect Capstead's liquidity, financial condition and earnings. Capstead's earnings depend primarily on the difference between the interest received on its residential mortgage investments and the interest paid on its related borrowings, net of the effect of derivatives held for hedging purposes. The Company typically finances its investments at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on related borrowings not effectively fixed through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more extreme circumstances, negative financing spreads and, therefore, adversely affect earnings. Because rising interest rates tend to put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods adversely affecting the Company's liquidity. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

Index

During periods of relatively low short-term interest rates, declines in the indices used to determine coupon interest rate resets for ARM loans may adversely affect yields on the Company's ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company's borrowing rates, earnings would be adversely affected.

Periods of illiquidity in the mortgage markets may reduce amounts available to be borrowed under Capstead's repurchase arrangements due to declines in the perceived value of related collateral, which could adversely impact the Company's liquidity, financial condition and earnings. Capstead generally finances its residential mortgage investments by pledging them as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis. The amount borrowed under a repurchase arrangement is limited to a percentage of the estimated market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by the lender that is not advanced under the repurchase arrangement is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the perceived market value of the pledged collateral as determined by the Company's lenders declines, the Company may be subject to margin calls wherein the lender requires the Company to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, Capstead may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to the Company and/or the amounts individual counterparties are willing to lend via repurchase arrangements, which could adversely affect the Company's liquidity, financial condition and earnings. Capstead enters into repurchase arrangements with numerous commercial banks and other financial institutions, both foreign and domestic, routinely with maturities of 30 to 90 days. The Company's ability to achieve its investment objectives depends on its ability to re-establish or roll maturing borrowings on a continuous basis and none of the Company's counterparties are obligated to enter into new repurchase transactions at the conclusion of existing transactions. If a counterparty chooses not to roll a maturing borrowing, the Company must pay off the borrowing, generally with cash available from another repurchase arrangement entered into with another counterparty. If the Company determines that it does not have sufficient borrowing capacity with its remaining counterparties, it could be forced to reduce its portfolio leverage by selling assets under potentially adverse market conditions, resulting in losses. This risk is increased if Capstead relies significantly on any single counterparty for a significant portion of its repurchase arrangements. An industry-wide reduction in the availability of borrowings under repurchase arrangements could adversely affect pricing levels for Agency Securities leading to further declines in the Company's liquidity and book value per common share. Under these conditions, the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

-38-

Index

If Capstead is unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of the Company's lending counterparties, the Company's liquidity, financial condition and earnings could be adversely impacted. The terms and conditions of each repurchase arrangement are negotiated on a transaction-by-transaction basis, and these borrowings generally are re-established, or rolled, at maturity. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on its future repurchase arrangements. For instance, during periods of market illiquidity or due to perceived credit deterioration of the collateral pledged or the Company itself, a lender may require that less favorable asset pricing procedures be employed, margin requirements be increased and/or may choose to limit or completely curtail lending to the Company. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

Capstead's use of repurchase arrangements to finance its investments may expose the Company to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to the Company. Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a simultaneous agreement to repurchase the transferred assets at a future date. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to the Company and subject the Company to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

Capstead's use of repurchase arrangements to finance its investments may give the Company's lending counterparties greater rights if the Company seeks bankruptcy protection, exposing the Company to losses. Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. If the Company files for bankruptcy, its lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses to the extent of any margin amounts held by the lending counterparties.

Capstead may sell assets for various reasons, including a change in the Company's investment focus, which could increase earnings volatility. Capstead may periodically sell assets to enhance its liquidity during periods of market illiquidity or rising interest rates or the Company may change its investment focus requiring it to sell some portion of its existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-dated repurchase arrangements or interest rate swap agreements, could increase the Company's earnings volatility.

Capstead may invest in derivative financial instruments such as interest rate swap agreements to mitigate or hedge the Company's interest rate risk, which may adversely affect the Company's liquidity, financial condition or earnings. The Company may invest in such instruments from time to time with the goal of achieving more stable borrowing costs over an extended period. However, these activities may not have the desired beneficial impact on the Company's liquidity, financial condition or earnings. For instance, the pricing of residential mortgage investments and the pricing of related derivatives may deteriorate at the same time leading to margin calls by counterparties to both the borrowings supporting these investments and the derivatives, adversely impacting the Company's liquidity and financial condition. In addition, counterparties could fail to honor their commitments under the terms of the derivatives or have their credit quality downgraded impairing the value of the derivatives. In the event of any defaults by counterparties, the Company may have difficulty recovering its cash collateral receivable from its counterparties and may not receive payments provided for under the terms of the derivatives and as a result, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

Index

Derivative financial instruments held may fail to qualify for hedge accounting introducing potential volatility to Capstead's earnings. The Company typically qualifies derivative financial instruments held as cash flow hedges for accounting purposes in order to record the effective portion of the change in fair value of derivatives as a component of stockholders' equity rather than in earnings. If the hedging relationship for any derivative held ceases to qualify for hedge accounting treatment for any reason, including failing to meet documentation and ongoing hedge effectiveness requirements, the Company would be required to record in earnings the total change in fair value of any such derivative. In addition the Company could elect to no longer avail itself of cash flow hedge accounting for its derivative positions. Such changes could introduce a potentially significant amount of volatility to earnings reported by the Company.

The lack of availability of suitable investments at attractive pricing may adversely affect Capstead's earnings. The pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than Capstead. Additionally, in recent years the federal government, primarily through the Federal Reserve, has been an active buyer of Agency Securities which has had the effect of supporting, if not increasing, pricing for these securities. To the extent the proceeds from prepayments on Capstead's mortgage investments are not reinvested or cannot be reinvested at rates of return at least equal to the rates previously earned on those investments, the Company's earnings may be adversely affected. Similarly, if proceeds from capital raising activities are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can the Company assure investors that it will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects. As a self-managed REIT with 13 full-time employees and one part-time employee, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. Although the Company's named executive officers and some of its other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

Risks Related to Capstead's Status as a REIT and Other Tax Matters

If Capstead does not qualify as a REIT, the Company will be subject to tax as a regular corporation and face substantial tax liability. Capstead has elected to be taxed as a REIT for federal income tax purposes and intends to continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize the Company's REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for the Company to qualify as a REIT.

If Capstead fails to qualify as a REIT in any tax year, then:

The Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates;

Index

Any resulting tax liability could be substantial and would reduce the cash available for distribution to stockholders, and the Company would not be required to make income distributions; and

Unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years and, as a result, the Company's cash available for distribution to stockholders would be reduced during these years.

Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings. Even if Capstead remains qualified for taxation as a REIT, the Company may be subject to certain federal, state and local taxes on its income and assets. For example, the Company:

- will be required to pay tax on any undistributed REIT taxable income,
- may be subject to the "alternative minimum tax" on any tax preference items, and
- may operate taxable REIT subsidiaries subject to tax on any taxable income earned.

Complying with REIT requirements may limit Capstead's ability to hedge effectively. The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from unqualified hedges together with any other income not generated from qualified real estate assets, to no more than 25% of gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect the profitability of these transactions or activities. If the Company fails to satisfy the REIT gross income tests it could lose its REIT status for federal income tax purposes unless the failure was due to reasonable cause and not due to willful neglect.

Complying with REIT requirements may cause Capstead to forego otherwise attractive opportunities. To qualify as a REIT for federal income tax purposes, Capstead must continually satisfy tests concerning, among other things, the sources of its income, the nature and diversification of its assets, the amounts that it distributes to its stockholders, and the ownership of its stock. The Company may be required to make distributions to stockholders at disadvantageous times or when it does not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder the Company's ability to operate solely on the basis of maximizing profits.

Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments. To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of the Company's investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of the Company's assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

Index

Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders. As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed taxable income. In addition, the Company will be subject to a 4% nondeductible excise tax if the actual amount that it pays out to its stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, the Company may generate taxable income greater than its net income for financial reporting purposes or its taxable income may be greater than the Company's cash flow available for distribution to stockholders. If the Company does not have other funds available in these situations, it could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable it to pay out enough of its taxable income to satisfy the distribution requirement and to avoid corporate income tax or the 4% excise tax in a particular year. These alternatives could increase the Company's costs and reduce its long-term investment capital.

Capstead may be subject to adverse legislative or regulatory tax changes that could reduce the market price of the Company's securities. Federal income tax laws governing REITs or the administrative interpretations of those laws may change at any time. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect Capstead or its stockholders. Capstead cannot predict any impact on the value of its securities from adverse legislative or regulatory tax changes.

An investment in Capstead's securities has various federal, state and local income tax risks that could affect the value of an investor's investment. The Company strongly urges investors to consult their own tax advisor concerning the effects of federal, state and local income tax law on an investment in the Company's securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

Risk Factors Related to Capstead's Corporate Structure

There are no assurances of Capstead's ability to pay dividends in the future. Capstead intends to continue paying quarterly dividends and to make distributions to its stockholders in amounts such that all or substantially all of the Company's taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable the Company to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, the Company's ability to pay dividends may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of the Company's board of directors and will depend upon the Company's earnings, its financial condition, maintenance of its REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of the Company's ability to pay dividends in the future.

Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations. The Investment Company Act of 1940 (the "40 Act") exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the 40 Act. For over 30 years, the staff of the SEC has interpreted the provisions of the 40 Act to require, among other things, a REIT to maintain at least 55% of its assets directly in qualifying real estate interests and at least 80% of its assets in real estate-related assets in order to be exempt from regulation as an investment company. Critical to Capstead's exemption from regulation as an investment company is the long-standing SEC staff interpretation that so called whole loan mortgage securities, in which an investor holds all issued certificates with respect to an underlying pool of mortgage loans, constitutes a qualifying real estate interest for purposes of the staff's 55% qualifying real estate interest requirement.

Index

Conversely, so called partial pool mortgage securities presently do not qualify for purposes of meeting the 55% requirement, although they are considered by the staff to be real estate-related assets for purposes of meeting the staff's 80% real estate-related asset requirement.

In August 2011, the SEC staff issued a request for information (Concept Release No. IC-29778) from industry participants and investors regarding, among other things, its past interpretations of the 40 Act real estate exemption, including the interpretations described above, raising concerns that the SEC may issue a proposal for rulemaking that could overturn some of the staff's past interpretations regarding the real estate exemption. If the SEC or its staff adopts contrary interpretations of the 40 Act and the Company and other similar REITs become subject to regulation as investment companies, the industry's use of leverage would be substantially reduced. Absent a restructuring of the Company's business operations to avoid such regulation, this could require the sale of most of the Company's portfolio of Agency Securities under potentially adverse market conditions resulting in losses and significantly reduce future net interest margins and earnings.

Pursuant to Capstead's charter, its board of directors has the ability to limit ownership of the Company's capital stock, to the extent necessary to preserve its REIT qualification. For the purpose of preserving Capstead's REIT qualification, the Company's charter gives the board the ability to repurchase outstanding shares of capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of the Company's outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

Because provisions contained in Maryland law and Capstead's charter may have an anti-takeover effect, investors may be prevented from receiving a "control premium" for their shares. Provisions contained in Capstead's charter and Maryland general corporation law can delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a "control premium" for their shares. For example, these provisions may defer or prevent tender offers for the Company's common stock or purchases of large blocks of the Company's common stock, thereby limiting the opportunities for its stockholders to receive a premium over then-prevailing market prices. These provisions include the following:

Repurchase rights: Repurchase rights granted to Capstead's board in its charter limit related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize the Company's REIT status.

Classification of preferred stock: Capstead's charter authorizes the board to issue preferred stock and establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval and could have the effect of delaying or preventing someone from taking control of the Company.

Statutory provisions: Capstead is subject to provisions of Maryland statutory law that restrict business combinations with interested stockholders and restrict voting rights of certain shares acquired in control share acquisitions. The board has not taken any action to exempt the Company from these provisions.

Index

Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of Maryland corporations may not be required to act in takeover situations under the same standards as apply in Delaware and certain other corporate jurisdictions

There are risks associated with ownership of Capstead's Series E Preferred Stock. Risks associated with ownership of the Company's Series E preferred shares include:

Redemption rights: The Series E preferred shares are redeemable by the Company, in whole or in part, at any time on or after May 13, 2018, or pursuant to a Special Optional Redemption Right upon the occurrence of a Change of Control, as both terms are defined in the Series E Articles Supplementary, at a cash redemption price of \$25.00 plus all accrued and unpaid dividends to, but not including, the date of redemption, which may be less than the prevailing market price for the Series E preferred shares.

Limited conversion rights: Holders of the Series E preferred shares may convert into common shares only upon the occurrence of a Change of Control, and only if the Company does not exercise its Special Optional Redemption Right. Even if this were to occur, it may not be economically advantageous to convert based on then existing conversion ratios and trading levels of the Company's common shares.

Subordination: The Series E preferred shares are subordinate to all of the Company's existing and future debt. None of the provisions relating to the Series E preferred shares limit the Company's ability to incur future debt. Future debt may include restrictions on the Company's ability to pay dividends on, redeem, or pay the liquidation preference on, the Series E preferred shares.

Dilution through issuance of additional preferred shares: The Company's charter currently authorizes the issuance of up to 100 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to the Series E preferred shares would dilute the interests of Series E preferred stockholders, and could affect the Company's ability to pay dividends on, redeem, or pay the liquidation preference on, the Series E preferred shares. None of the provisions relating to Series E preferred shares limit the Company's ability to issue additional preferred stock on parity with Series E preferred shares.

Limited voting rights: Voting rights as a holder of Series E preferred shares are limited. The Company's common stock is currently the only class of stock carrying full voting rights. Voting rights for holders of Series E preferred shares exist primarily with respect to (i) adverse changes in the terms of the Series E preferred shares, (ii) the creation of additional classes or series of preferred stock that are senior to the Series E preferred shares, and (iii) the non-payment of six quarterly dividends (whether or not consecutive) are in arrears.

Capstead may change its policies without stockholder approval. Capstead's board and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company's stockholders. Policy changes could adversely affect the Company's financial condition, results of operations, the market price of its common and preferred stock or the Company's ability to pay dividends or distribution.

Index

CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of financial condition and results of operations is based upon Capstead's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that can affect the reported amounts of assets, liabilities (including contingencies), revenues and expenses, as well as related disclosures. These estimates are based on available internal and market information and appropriate valuation methodologies believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the expected useful lives and carrying values of assets and liabilities which can materially affect the determination of net income and book value per common share. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following are critical accounting policies in the preparation of Capstead's consolidated financial statements that involve the use of estimates requiring considerable judgment:

Amortization of investment premiums on residential mortgage investments – Investment premiums on residential mortgage investments are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. The single largest determinant in amortizing investment premiums is actual portfolio runoff (scheduled and unscheduled principal paydowns) for a given accounting period. This is because the investment premium associated with actual runoff is effectively written off (amortized) when the runoff occurs pursuant to the interest method. Amortization is also affected by estimates and judgments related to future levels of mortgage prepayments used in determining additional amortization that may be necessary to achieve the required effective yield over the estimated life of the related investment. Mortgage prepayment expectations can change based on how current and projected changes in interest rates impact the economic attractiveness of mortgage refinance opportunities, if available, and other factors such as lending industry underwriting practices and capacity constraints, regulatory changes, borrower credit profiles and the health of the economy and housing markets. Management estimates mortgage prepayments based these factors and past experiences with specific investments within the portfolio. Should actual prepayment rates differ materially from these estimates, investment premiums would be expensed at a different pace.

Fair value and impairment accounting for residential mortgage investments – Nearly all of Capstead's residential mortgage investments are held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in Stockholders' equity as a component of Accumulated other comprehensive income. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions. Considerable judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 9 to the consolidated financial statements (included under Item 1 of this report) for discussion of how Capstead values its residential mortgage investments. Generally, gains or losses are recognized in earnings only if sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of Other revenue (expense) if the decline was credit-related or it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary impairment of a mortgage security due to other factors would be recognized in Accumulated other comprehensive income.

Index

Accounting for derivative financial instruments – Capstead uses derivatives for risk management purposes. Derivatives are recorded as assets or liabilities and carried at fair value and consequently, changes in value of these instruments enter into the calculation of book value per common share. Fair values fluctuate with current and projected changes in interest rates and other factors such as the Company’s and its counterparties’ nonperformance risk. Judgment is required to develop estimated fair values.

The accounting for changes in fair value of each derivative held depends on whether it has been designated as an accounting hedge, as well as the type of hedging relationship identified. To qualify as a cash flow hedge for accounting purposes, at the inception of the hedge relationship the Company must anticipate and document that the hedge relationship will be highly effective and must monitor ongoing effectiveness on at least a quarterly basis. As long as the hedge relationship remains effective, the effective portion of changes in fair value of the derivative is recorded in Accumulated other comprehensive income and the ineffective portion is recorded in earnings as a component of Interest expense. The effective portion of changes in fair value is reclassified from Accumulated comprehensive income to earnings over the term of the derivative primarily in the form of derivative cash flows that are either in excess of or lower than market rates. Changes in fair value of derivatives not held as accounting hedges, or for which the hedge relationship is deemed to no longer be highly effective and as a result hedge accounting is terminated, are recorded in earnings as a component of Other revenue (expense).

The Company currently uses interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of its current and anticipated future 30- and 90-day borrowings and the 20-year floating-rate periods of the Company’s long-term unsecured borrowings. Variable-rate payments to be received on the swap agreements and any measured hedge ineffectiveness are recorded in interest expense as an offset to interest owed on the hedged borrowings that reset to market rates generally on a monthly basis while fixed rate swap payments to be made are also recorded in interest expense resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTE 7 to the consolidated financial statements (included under Item 1 of this report) and “Financial Condition–Residential Mortgage Investments” for additional information regarding the Company’s current use of derivatives and its related risk management policies.

STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

This document contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain the words “believe,” “anticipate,” “expect,” “estimate,” “intend,” “will be,” “will likely continue,” “will likely result,” or words or phrases of similar meaning. Forward-looking statements are based largely on the expectations of management and are subject to a number of risks and uncertainties including, but not limited to, the following:

- changes in general economic conditions;
- fluctuations in interest rates and levels of mortgage prepayments;
- the effectiveness of risk management strategies;
- the impact of differing levels of leverage employed;

Index

- liquidity of secondary markets and credit markets;
- the availability of financing at reasonable levels and terms to support investing on a leveraged basis;
- the availability of new investment capital;
- the availability of suitable qualifying investments from both an investment return and regulatory perspective;
- changes in legislation or regulation affecting the GSEs, Ginnie Mae and similar federal government agencies and related guarantees;
- other changes in legislation or regulation affecting the mortgage and banking industries;
- changes in market conditions as a result of Federal Reserve monetary policy or federal government fiscal challenges;
- deterioration in credit quality and ratings of existing or future issuances of GSE or Ginnie Mae securities;
- changes in legislation or regulation affecting exemptions for mortgage REITs from regulation under the Investment Company Act of 1940; and
- increases in costs and other general competitive factors.

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. Forward-looking statements speak only as of the date the statement is made and the Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS

The information required by this Item is incorporated by reference to the information included in Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations."

ITEM 4. CONTROLS AND PROCEDURES

As of March 31, 2014, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2014. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to March 31, 2014.

Index

PART II. $\frac{3}{4}$ OTHER INFORMATION

ITEM 6. EXHIBITS

Exhibit

Number DESCRIPTION

- 3.1 Charter, including Articles of Incorporation, Articles Supplementary for each series of preferred shares (except the 7.50% Series E Cumulative Redeemable Preferred Stock) and all other amendments to such Articles of Incorporation.⁽¹⁾
- 3.2 Articles Supplementary classifying and designating the Registrant's 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, par value \$0.10 per share.⁽²⁾
- 3.3 Amended and Restated Bylaws.⁽³⁾
- 4.1 Specimen of Common Stock Certificate.⁽⁴⁾
- 4.2 Specimen of stock certificate evidencing the 7.50% Series E Cumulative Redeemable Preferred Stock of the Registrant, liquidation preference \$25.00 per share, par value \$0.10 per share.⁽²⁾
- 4.3 Junior Subordinated Indenture dated September 26, 2005.⁽⁵⁾
- 4.4 Indenture dated December 15, 2005.⁽⁵⁾
- 4.5 Indenture dated September 11, 2006.⁽⁵⁾
- 10.01 Amended and Restated Deferred Compensation Plan.⁽⁵⁾
- 10.02 Amended and Restated 2004 Flexible Long-Term Incentive Plan.⁽⁶⁾
- 10.03 Second Amended and Restated Incentive Bonus Plan.⁽⁷⁾
- 10.04 Form of nonqualified stock option and stock award agreements for non-employee directors.⁽⁵⁾
- 10.05 Form of nonqualified stock option and stock award agreements for employees with service conditions.⁽⁵⁾
- 10.06 Form of stock award agreements for employees with performance conditions.⁽⁸⁾
- 10.07 Form of stock award agreements for employees with performance conditions and deferral of dividends.⁽⁹⁾
- 10.08 2013 Annual Incentive Plan (short-term).⁽¹⁰⁾
- 10.09 2014 Annual Incentive Compensation Program (short-term).⁽³⁾
- 10.10 2014 Long-Term Award Criteria, as corrected.⁽³⁾
- 10.11 Form of Performance Unit Agreement, as corrected.⁽³⁾
- 10.12 Sales Agreement, dated November 12, 2013, by and between the Company and the Sales Manager.⁽¹¹⁾
- 12 Computation of ratio of net income to fixed charges and ratio of net income to combined fixed charges and preferred stock dividends.*
- 31.1 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
- 31.2 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**
- 101.INS XBRL Instance Document***
- 101.SCH XBRL Taxonomy Extension Schema***
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase***
- 101.DEF XBRL Additional Taxonomy Extension Definition Linkbase***
- 101.LAB XBRL Taxonomy Extension Label Linkbase***
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase***

(1) Incorporated by reference to the Registrant's Annual Report on Form 10-K/A for the year ended December 31, 2012.

(2) Incorporated by reference to the Registrant's Registration of Certain Classes of Securities on Form 8-A dated May 13, 2013.

(3) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on February 3, 2014, for the event dated January 29, 2014.

(4) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-63358) dated June 19, 2001.

-48-

Index

- (5) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011.
- (6) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013.
- (7) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on May 5, 2011, for the event dated May 4, 2011.
- (8) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008.
- (9) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2010.
- (10) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on October 23, 2013 for the event dated October 21, 2013.
- (11) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on November 13, 2013, for the event dated November 12, 2013.

* Filed herewith

** Furnished herewith

*** Submitted electronically herewith

SIGNATURES

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

CAPSTEAD MORTGAGE CORPORATION
Registrant

Date: May 9, 2014 By: /s/ ANDREW F. JACOBS
Andrew F. Jacobs
President and Chief Executive Officer

Date: May 9, 2014 By: /s/ PHILLIP A. REINSCH
Phillip A. Reinsch
Executive Vice President and Chief Financial Officer