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Ellington Residential Mortgage REIT  
Form 10-Q  
November 12, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 001-35896  
Ellington Residential Mortgage REIT  
(Exact Name of Registrant as Specified in Its Charter)

Maryland 46-0687599  
(State or Other Jurisdiction of Incorporation) (IRS Employer Identification No.)  
53 Forest Avenue  
Old Greenwich, CT 06870  
(Address of principal executive offices, zip code)  
(203) 698-1200  
(Registrant's Telephone Number, Including Area Code)

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

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

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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer (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

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

Class Outstanding at November 7, 2014  
Common Shares of Beneficial Interest, \$0.01 par value per share 9,149,274



ELLINGTON RESIDENTIAL MORTGAGE REIT  
FORM 10-Q

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## PART I. FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements (unaudited)

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

	September 30, 2014	December 31, 2013
(In thousands except share amounts)		
<b>ASSETS</b>		
Cash and cash equivalents	\$51,063	\$50,112
Mortgage-backed securities, at fair value	1,368,092	1,326,036
Due from brokers	20,071	18,347
Financial derivatives—assets, at fair value	8,439	34,963
Reverse repurchase agreements	2,484	—
Receivable for securities sold	25,945	76,692
Interest receivable	5,601	4,766
Other assets	497	174
Total Assets	\$1,482,192	\$1,511,090
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Repurchase agreements	\$1,233,333	\$1,310,347
Payable for securities purchased	63,143	2,776
Due to brokers	3,889	22,788
Financial derivatives—liabilities, at fair value	2,850	1,069
U.S. Treasury securities sold short, at fair value	2,483	—
Dividend payable	5,032	4,570
Accrued expenses	754	996
Management fee payable	574	600
Interest payable	591	764
Total Liabilities	1,312,649	1,343,910
<b>SHAREHOLDERS' EQUITY</b>		
Preferred shares, par value \$0.01 per share, 100,000,000 shares authorized; (0 shares issued and outstanding, respectively)	—	—
Common shares, par value \$0.01 per share, 500,000,000 shares authorized; (9,149,274 and 9,139,842 shares issued and outstanding, respectively)	91	91
Additional paid-in-capital	181,252	181,147
Accumulated deficit	(11,800	) (14,058
Total Shareholders' Equity	169,543	167,180
Total Liabilities and Shareholders' Equity	\$1,482,192	\$1,511,090

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF OPERATIONS  
(UNAUDITED)

	Three Month Period Ended September 30, 2014	Three Month Period Ended September 30, 2013	Nine Month Period Ended September 30, 2014	Nine Month Period Ended September 30, 2013
(In thousands except per share amounts)				
<b>INTEREST INCOME (EXPENSE)</b>				
Interest income	\$11,484	\$11,223	\$35,018	\$15,815
Interest expense	(1,121)	(1,248)	(3,346)	(1,773)
Total net interest income	10,363	9,975	31,672	14,042
<b>EXPENSES</b>				
Management fees	574	644	1,733	1,466
Professional fees	123	200	399	468
Other operating expenses	597	513	1,873	980
Total expenses	1,294	1,357	4,005	2,914
<b>OTHER INCOME (LOSS)</b>				
Net realized gains (losses) on mortgage-backed securities	2,030	(24,173)	(613)	(26,290)
Net realized gains (losses) on financial derivatives	(4,391)	4,273	(18,955)	12,650
Change in net unrealized gains (losses) on mortgage-backed securities	(5,455)	30,239	37,550	(15,391)
Change in net unrealized gains (losses) on financial derivatives	2,280	(12,172)	(28,305)	16,114
Total other income (loss)	(5,536)	(1,833)	(10,323)	(12,917)
<b>NET INCOME (LOSS)</b>	<b>\$3,533</b>	<b>\$6,785</b>	<b>\$17,344</b>	<b>\$(1,789)</b>
<b>NET INCOME (LOSS) PER COMMON SHARE:</b>				
Basic and Diluted	\$0.39	\$0.74	\$1.90	\$(0.31)
<b>CASH DIVIDENDS PER COMMON SHARE:</b>				
Dividends declared	\$0.55	0.50	\$1.65	\$0.64

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
(UNAUDITED)

	Common Shares	Common Shares, par value	Preferred Shares	Preferred Shares, par value	Additional Paid-in-Capital	Accumulated Deficit	Total
(In thousands except share amounts)							
BALANCE, December 31, 2012	1,633,378	\$16	—	\$—	\$ 32,674	\$(1,726)	\$30,964
Issuance of common shares	7,500,000	75	—	—	149,925		150,000
Issuance of restricted shares	6,464	—	—	—	—		—
Share based compensation					3		3
Offering costs					(1,498)		(1,498)
Dividends declared						(5,848)	(5,848)
Net loss						(1,789)	(1,789)
BALANCE, September 30, 2013	9,139,842	\$91	—	\$—	\$ 181,104	\$(9,363)	\$171,832
BALANCE, December 31, 2013	9,139,842	\$91	—	\$—	\$ 181,147	\$(14,058)	\$167,180
Issuance of restricted shares	9,432	—	—	—	—		—
Share based compensation					105		105
Dividends declared						(15,086)	(15,086)
Net income						17,344	17,344
BALANCE, September 30, 2014	9,149,274	\$91	—	\$—	\$ 181,252	\$(11,800)	\$169,543

See Notes to Consolidated Financial Statements

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ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

	Nine Month Period Ended September 30, 2014	Nine Month Period Ended September 30, 2013
(In thousands)		
Cash flows provided by (used in) operating activities:		
Net income (loss)	\$17,344	\$(1,789)
Reconciliation of net income to net cash provided by (used in) operating activities:		
Net realized (gains) losses on mortgage-backed securities	613	26,290
Change in net unrealized (gains) losses on mortgage-backed securities	(37,550)	) 15,391
Net realized (gains) losses on financial derivatives	18,955	(12,650)
Change in net unrealized (gains) losses on financial derivatives	28,305	(16,114)
Amortization of premiums and accretion of discounts (net)	5,254	2,498
Share based compensation	105	3
(Increase) decrease in assets:		
Due from brokers	(1,724)	) (13,724)
Interest receivable	(835)	) (4,331)
Other assets	(258)	) (261)
Increase (decrease) in liabilities:		
Due to brokers	(18,899)	) 22,160
Accrued expenses	(69)	) 14
Interest payable	(173)	) 597
Management fees payable	(26)	) 528
Net cash provided by operating activities	11,042	18,612
Cash flows provided by (used in) investing activities:		
Purchases of mortgage-backed securities	(1,478,619)	) (2,365,561)
Proceeds from sale of mortgage-backed securities	1,506,513	891,017
Principal repayments of mortgage-backed securities	72,761	29,276
Proceeds from investments sold short	141,527	2,043
Repurchase of investments sold short	(138,957)	) (2,036)
Proceeds from disposition of financial derivatives	7,592	24,849
Purchase of financial derivatives	(26,547)	) (12,199)
Payments made on reverse repurchase agreements	(712,899)	) (4,098)
Proceeds from reverse repurchase agreements	710,415	4,098
Net cash provided by (used in) investing activities	81,786	(1,432,611)
Cash flows provided by (used in) financing activities:		
Proceeds from issuance of common shares	—	150,000
Offering costs paid	(239)	) (1,498)
Dividends paid	(14,624)	) (1,279)
Borrowings under repurchase agreements	4,484,173	4,424,530
Repayments of repurchase agreements	(4,561,187)	) (3,131,584)
Cash provided by (used in) financing activities	(91,877)	) 1,440,169
NET INCREASE IN CASH AND CASH EQUIVALENTS	951	26,170
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	50,112	18,161
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$51,063	\$44,331

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Supplemental disclosure of cash flow information:

Interest paid	\$3,520	\$1,176
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See Notes to Consolidated Financial Statements

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ELLINGTON RESIDENTIAL MORTGAGE REIT  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(UNAUDITED)

1. Organization and Investment Objective

Ellington Residential Mortgage REIT, or "EARN," was formed as a Maryland real estate investment trust, or "REIT," on August 2, 2012, and commenced operations on September 25, 2012. EARN conducts its business through its wholly owned subsidiaries, EARN OP GP LLC, or the "General Partner," and Ellington Residential Mortgage LP, or the "Operating Partnership," which were formed as a Delaware limited liability company and a Delaware limited partnership, respectively, on July 31, 2012 and commenced operations on September 25, 2012. The Operating Partnership conducts its business of acquiring, investing in, and managing residential mortgage-related and real estate-related assets through its wholly owned subsidiaries. EARN, the General Partner, the Operating Partnership, and their consolidated subsidiaries are hereafter defined as the "Company."

Ellington Residential Mortgage Management LLC, or the "Manager," serves as the Manager of the Company pursuant to the terms of the Second Amended and Restated Management Agreement effective as of March 13, 2014, or the "Management Agreement." The Manager is an affiliate of Ellington Management Group, L.L.C., or "EMG," an investment management firm that is registered as an investment adviser with a 19-year history of investing in a broad spectrum of mortgage-backed securities and related derivatives, with an emphasis on the residential mortgage-backed securities, or "RMBS," market. In accordance with the terms of the Management Agreement and the Services Agreement, as discussed in Note 10, the Manager is responsible for administering the Company's business activities and day-to-day operations, and performs certain services, subject to oversight by the Board of Trustees.

The Company was formed through an initial strategic venture among affiliates of EMG and the Blackstone Tactical Opportunity Funds, or the "Blackstone Funds." These initial investors made an aggregate investment of approximately \$31.5 million on September 25, 2012. On May 1, 2013, the Company priced an initial public offering of its common shares, pursuant to which it sold 6,450,000 shares to the public at a price of \$20.00 per share. Concurrent with the initial public offering, the Company completed a private placement of 1,050,000 common shares to its initial investors at a purchase price of \$20.00 per share which generated gross proceeds of \$21.0 million. Proceeds to the Company, net of offering costs, were approximately \$148.5 million.

The Company acquires and manages Agency and non-Agency RMBS, including Agency pools and Agency collateralized mortgage obligations, or "CMOs," and non-Agency CMOs, both investment grade and non-investment grade. The Company may also acquire and manage mortgage servicing rights, residential mortgage loans, and other mortgage- and real estate-related assets. The Company may also invest in other instruments including, but not limited to, forward-settling To-Be-Announced Agency pass-through certificates, or "TBAs," interest rate swaps and swaptions, U.S. Treasury securities, Eurodollar and U.S. Treasury futures, other financial derivatives, and cash equivalents. The Company's targeted investments may range from unrated (first loss) securities to AAA senior securities.

The Company made the election to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, or "the Code" commencing with the Company's short taxable year ended December 31, 2013. As a REIT, the Company is required to distribute annually at least 90% of its taxable income. As long as the Company continues to qualify as a REIT, it will not be subject to U.S. federal or state corporate taxes on its taxable income to the extent that it distributes all of its annual taxable income to its shareholders. It is the intention of the Company to distribute at least 100% of its taxable income, after application of available tax attributes, within the limits prescribed by the Code, which may extend into the subsequent taxable year.

2. Significant Accounting Policies

(A) Basis of Presentation: The Company's unaudited interim consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America, or "U.S. GAAP." Entities in which the Company has a controlling financial interest, through ownership of the majority of the entities' voting equity interests, or through other contractual right that give the Company control, are consolidated by the Company. All inter-company balances and transactions have been eliminated. The preparation of consolidated financial

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statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and those differences could be material. Interim results are not necessarily indicative of the results that may be expected for the entire fiscal year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

(B) Valuation: The Company applies Accounting Standards Codification, or "ASC," ASC 820-10, Fair Value Measurement and Disclosures ("ASC 820-10"), to its holdings of financial instruments. ASC 820-10 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

• Level 1—inputs to the valuation methodology are observable and reflect quoted prices (unadjusted) for identical assets or liabilities in active markets,

• Level 2—inputs to the valuation methodology other than quoted prices included in Level 1 are observable for the asset or liability, either directly or indirectly, and

• Level 3—inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in these securities.

(C) Accounting for Mortgage-Backed Securities: Investments in mortgage-backed securities are recorded on trade date. The Company has chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for its mortgage-backed securities portfolio. Electing the fair value option allows the Company to record changes in fair value in the Consolidated Statement of Operations, which, in management's view, more appropriately reflects the results of operations for a particular reporting period as all securities activities will be recorded in a similar manner. As such, the mortgage-backed securities are recorded at fair value on the Consolidated Balance Sheet and the period change in fair value is recorded in current period earnings on the Consolidated Statement of Operations as a component of Change in net unrealized gains (losses) on mortgage-backed securities.

Realized gains or losses on sales of mortgage-backed securities are included in Net realized gains (losses) on mortgage-backed securities on the Consolidated Statement of Operations, and are recorded at the time of disposition. The cost of positions sold is calculated based on identified cost.

(D) Interest Income: The Company accretes market discounts and amortizes market premiums on debt securities using the effective yield method. Accretion of market discount and amortization of market premiums requires the application of several assumptions including, but not limited to, prepayment assumptions and default rate assumptions, which are re-evaluated not less than quarterly and require the use of a significant amount of judgment. Principal write-offs are generally treated as realized losses. The Company's accretion of discounts and amortization of premiums for U.S. federal and other tax purposes is likely to differ from the financial accounting treatment under U.S. GAAP of these items as described above.

(E) Cash and Cash Equivalents: Cash and cash equivalents include cash and short term investments with original maturities of three months or less at the date of acquisition. Cash equivalents are recorded at cost plus accrued interest, which approximates fair value. Cash accounts are maintained with financial institutions and these balances generally exceed insured limits.

(F) Due from brokers/Due to brokers: Due from brokers and Due to brokers accounts on the Consolidated Balance Sheet include collateral paid or received from counterparties, including clearinghouses, along with receivables and payables for open and or closed derivative positions.

(G) Financial Derivatives: The Company may enter into various types of financial derivatives subject to its investment guidelines, which include restrictions associated with maintaining qualification as a REIT. The Company's financial derivatives are predominantly subject to bilateral collateral arrangements or clearing in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Company may be required to deliver or may receive cash or securities as collateral upon entering into derivative transactions. In addition, changes in the relative value of financial derivative transactions may require the Company or the counterparty to post or receive additional collateral. In the case of cleared financial derivatives, the clearinghouse becomes the Company's counterparty and a futures commission merchant, or "FCM," acts as intermediary between the Company and the clearinghouse with respect to all facets of the related transaction, including the posting and receipt of required collateral. Collateral received by the Company is reflected on the Consolidated Balance Sheet as "Due to Brokers." Conversely, collateral posted by the Company is reflected as "Due from Brokers" on the Consolidated Balance Sheet.

The types of financial derivatives that have been utilized by the Company to date are interest rate swaps, TBAs, swaptions, and futures.

Swaps: The Company has entered into interest rate swaps, which are contractual agreements whereby one party pays a floating rate of interest on a notional principal amount and receives a fixed rate on the same notional principal, or vice versa, for a fixed period of time.

While the Company does not intend to operate its non-Agency RMBS investment strategy on a credit hedged basis, the Company may opportunistically enter into various credit hedging transactions, such as involving credit default swaps, total return swaps, or other derivative contracts. The Company may use credit default swaps to hedge non-Agency RMBS credit risk by buying protection on a basket or index of non-Agency RMBS assets or on a single non-Agency RMBS. For credit hedging purposes the Company may also enter into credit default swaps which reference other mortgage-backed securities, or "MBS," or the corporate credit of certain corporations, or indices on the foregoing. In addition, the Company may enter into various other financial derivative contracts, including total return swaps. Generally, a total return swap would reference either the corporate credit or equity of certain corporations. However, the Company's ability to use credit hedges is subject to the Company's qualifying and maintaining its qualification as a REIT and maintaining its exclusion from regulation as an investment company under the Investment Company Act.

Swaps change in value with movements in interest rates or total return of the reference securities. During the term of swap contracts, changes in value are recognized as unrealized gains or losses on the Consolidated Statement of Operations. When a contract is terminated, the Company realizes a gain or loss equal to the difference between the proceeds from (or cost of) the closing transaction and the Company's basis in the contract, if any. Periodic payments or receipts required by swap agreements are recorded as unrealized gains or losses when accrued and realized gains or losses when received or paid. Upfront payments paid and/or received by the Company to open swap contracts are recorded as an asset and/or liability on the Consolidated Balance Sheet and are recorded as a realized gain or loss on the termination date.

**TBA Securities:** The Company has transacted in the forward settling To Be Announced RMBS ("TBA") market. A TBA position is a forward contract for the purchase ("long position") or sale ("short position") of Agency RMBS at a predetermined price, face amount, issuer, coupon, and maturity on an agreed-upon future delivery date. For each TBA contract and delivery month, a uniform settlement date for all market participants is determined by the Securities Industry and Financial Markets Association. The specific Agency RMBS to be delivered into the contract at the settlement date are not known at the time of the transaction. The Company typically does not take delivery of TBAs, but rather enters into offsetting transactions and settles the associated receivable and payable balances with its counterparties. The Company primarily uses TBAs to hedge interest rate risk, but from time to time it also holds net long positions in certain TBA securities as a means of acquiring exposure to Agency RMBS.

TBAs are accounted for by the Company as financial derivatives. The difference between the contract price and the fair value of the TBA position as of the reporting date is included in Change in net unrealized gains (losses) on financial derivatives, in the Consolidated Statement of Operations. The Company estimates the fair value of TBA positions based on similar methods used to value mortgage-backed securities. Upon settlement of the TBA contract, the realized gain (loss) on the TBA contract is equal to the net cash amount received (paid).

**Options:** The Company has entered into swaption contracts. It may purchase or write put, call, straddle, or other similar options contracts. The Company enters into options primarily to help mitigate interest rate risk. When the Company purchases an option, the option asset is initially recorded at an amount equal to the premium paid, if any, and is subsequently marked-to-market. Premiums paid for purchasing options that expire unexercised are recognized on the expiration date as realized losses. If an option is exercised, the premium paid is subtracted from the proceeds of the sale or added to the cost of the purchase to determine whether the Company has realized a gain or loss on the related investment transaction. When the Company writes an option, the option liability is initially recorded at an amount equal to the premium received, if any, and is subsequently marked-to-market. Premiums received for writing options that expire unexercised are recognized on the expiration date as realized gains. If an option is exercised, the premium received is subtracted from the cost of the purchase or added to the proceeds of the sale to determine whether the Company has realized a gain or loss on the related investment transaction. When the Company enters into a closing transaction, the Company will realize a gain or loss depending upon whether the amount from the closing transaction is greater or less than the premiums paid or received. In general, the Company's options contain forward-settling premiums. In this case, no money is exchanged upfront; instead, the agreed-upon premium is paid by the buyer upon expiration of the option, regardless of whether or not the option is exercised.

Futures Contracts: A futures contract is an exchange-traded agreement to buy or sell an asset for a set price on a future date. Initial margin deposits are made upon entering into futures contracts and can be either in the form of cash or securities. During the period the futures contract is open, changes in the value of the contract are recognized as unrealized gains or losses by marking-to-market to reflect the current market value of the contract. Variation margin payments are made or received periodically, depending upon whether unrealized losses or gains are incurred. When the contract is closed, the Company records a realized gain or loss equal to the difference between the proceeds of the closing transaction and the Company's basis in the contract.

Financial derivative assets are included in Financial derivatives—assets, at fair value on the Consolidated Balance Sheet while financial derivative liabilities are included in Financial derivatives—liabilities, at fair value on the Consolidated Balance Sheet.

(H) Repurchase Agreements and Reverse Repurchase Agreements: The Company enters into repurchase agreements with third-party broker-dealers, whereby it sells securities under agreements to repurchase at an agreed upon price and date. The Company also enters into reverse repurchase agreement transactions with third-party broker-dealers, whereby it purchases securities under agreements to resell at an agreed upon price and date. The Company accounts for repurchase agreements as collateralized borrowings, with the initial sale price representing the amount borrowed, and with the future repurchase price consisting of the amount borrowed plus interest, at the implied interest rate of the repurchase agreement, on the amount borrowed over the term of the repurchase agreement. The interest rate on a repurchase agreement or a reverse repurchase agreement is based on competitive market rates (or competitive market spreads, in the case of agreements with floating interest rates) at the time such agreement is entered into. When the Company enters into a repurchase agreement, the lender establishes and maintains an account containing cash and securities having a value not less than the repurchase price, including accrued interest, of the repurchase agreement. Repurchase and reverse repurchase agreements that are conducted with the same counterparty can be reported on a net basis if they meet the requirements under the authoritative guidance. Repurchase agreements and reverse repurchase agreements are carried at their contractual amounts, which approximate fair value.

(I) U.S. Treasury Securities: The Company may purchase or sell short U.S. Treasury securities to help mitigate the potential impact of changes in interest rates on the performance of its portfolio. The Company may borrow securities under reverse repurchase agreements to enable it to deliver U.S. Treasury securities that it has sold short.

(J) Offering Costs/Deferred Offering Costs: Offering costs are charged against shareholders' equity and typically include legal, accounting, printing, and other fees associated with the cost of raising equity capital.

(K) Share Based Compensation: The Company applies the provisions of ASC 718, Compensation—Shares Compensation ("ASC 718"), with regard to its equity incentive plans. ASC 718 covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. ASC 718 requires that compensation cost relating to share-based payment transactions be recognized in financial statements. The cost is measured based on the fair value of the equity or liability instruments issued.

(L) Dividends: Dividends payable are recorded on the declaration date.

(M) Earnings Per Share: In accordance with the provisions of ASC 260, Earnings per Share, the Company calculates basic income (loss) per share by dividing net income (loss) for the period by the weighted average of the Company's common shares outstanding for that period. Diluted income (loss) per share takes into account the effect of dilutive instruments, such as share options and warrants, and uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted average number of shares outstanding.

(N) Share Repurchases: Common shares that are repurchased by the Company subsequent to issuance decrease the total number of shares issued and outstanding.

(O) Income Taxes: Prior to May 1, 2013, the Company, as a business trust with more than one owner, was considered a partnership for U.S. federal income tax purposes. In general, partnerships are not subject to entity-level tax on their income, but the income of a partnership is taxable to its owners on a flow-through basis. Interest, dividend, and other income realized by the Company from non-U.S. sources and capital gains realized on the sale of securities of non-U.S. issuers may be subject to entity level tax such as withholding and other taxes levied by the jurisdiction in which the income is sourced. For the periods September 25, 2012 (commencement of operations) through December 31, 2012 and January 1, 2013 through April 30, 2013, the Company filed its tax return as a partnership. Effective May 1, 2013, the Company made the election to be taxed as a corporation. In addition, the Company elected to be taxed as a REIT under Sections 856 to 860 of the Code commencing with the short taxable period May 1, 2013 through December 31, 2013. To qualify as a REIT, the Company must meet certain requirements, including the distribution of at least 90% of its annual taxable income to shareholders.

The Company follows the authoritative guidance on accounting for and disclosure of uncertainty on tax positions, which requires management to determine whether a tax position of the company is more likely than not to be

sustained upon examination by the applicable taxing authority, including resolution of any related appeals of the litigation process, based on the technical merits of the position. For uncertain tax positions, the tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. The Company did not have any unrecognized tax benefits at December 31, 2013. In the normal course of business, the Company may be subject to examination by federal, state, local, and foreign jurisdictions, where applicable, for the current period, 2013, and 2012 (its open tax years). The Company may take positions with respect to certain tax issues which depend on legal interpretation of facts or applicable



tax regulations. Should the relevant tax regulators successfully challenge any of such positions, the Company might be found to have a tax liability that has not been recorded in the accompanying consolidated financial statements. Also, management's conclusions regarding the authoritative guidance may be subject to review and adjustment at a later date based on changing tax laws, regulations, and interpretations thereof. There were no amounts accrued for penalties or interest as of or during the periods presented in these consolidated financial statements.

(P) Recent Accounting Pronouncements: Under the Jumpstart Our Business Startups Act, or the "JOBS Act," the Company meets the definition of an "emerging growth company." The Company has elected to follow the extended transition period for complying with new or revised U.S. accounting standards pursuant to Section 107(b) of the JOBS Act. As a result, the Company will comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for non-public entities.

In June 2014, the FASB issued ASU No. 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures ("ASU 2014-11"). This amends ASC 860, Transfers and Servicing ("ASC 860"), to require disclosure of repurchase-to maturity transactions to be accounted for as secured borrowings rather than sales of an asset, and transfers of financial assets with a contemporaneous repo will no longer be evaluated to determine whether they should be accounted for on a combined basis as forward contracts. The new guidance also prescribes additional disclosures particularly on the nature of collateral pledged under repurchase agreements accounted for as secured borrowings. ASU 2014-11 is effective for interim and annual periods beginning after December 15, 2014. The adoption of ASC 860, as amended by ASU 2014-11 is not expected to have a material impact on the Company's consolidated financial statements.

### 3. Mortgage-Backed Securities

The following tables present details of the Company's mortgage-backed securities portfolio at September 30, 2014 and December 31, 2013, respectively. The Company's Agency RMBS include mortgage pass-through certificates and CMOs representing interests in or obligations backed by pools of residential mortgage loans issued or guaranteed by a U.S. government agency or government-sponsored enterprises, or "GSEs." The non-Agency RMBS portfolio is not issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any agency of the U.S. Government and is therefore subject to greater credit risk.

By RMBS Type –  
September 30, 2014:

(\$ in thousands)				Gross Unrealized			Weighted Average		
	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gains	Losses	Fair Value	Coupon	Yield	Weighted Average Life(Years) <sup>(1)</sup>
Agency RMBS:									
15-year fixed rate mortgages	\$136,558	\$6,498	\$143,056	\$524	\$(223)	\$143,357	3.40%	2.51%	5.55
20-year fixed rate mortgages	9,974	596	10,570	93	(1)	10,662	4.00%	3.44%	7.11
30-year fixed rate mortgages	1,036,799	55,491	1,092,290	11,061	(4,590)	1,098,761	4.04%	3.29%	8.98
Adjustable rate mortgages	43,288	2,945	46,233	121	(233)	46,121	4.63%	3.16%	6.03
Reverse mortgages	19,523	1,580	21,103	118	(4)	21,217	4.73%	2.77%	4.86

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Interest only securities	n/a	n/a	12,108	2,457	(323 )	14,242	4.19%	10.58%	3.55
Total Agency RMBS	1,246,142	67,110	1,325,360	14,374	(5,374 )	1,334,360	4.02%	3.26%	7.99
Non-Agency RMBS	52,785	(21,568 )	31,217	3,166	(651 )	33,732	2.30%	9.71%	5.22
Total RMBS	\$1,298,927	\$45,542	\$1,356,577	\$17,540	\$(6,025)	\$1,368,092	3.96%	3.41%	7.91

Average lives of RMBS are generally shorter than stated contractual maturities. Average lives are affected by the (1) contractual maturities of the underlying mortgages, scheduled periodic payments of principal, and unscheduled prepayments of principal.

For the three month and nine month periods ended September 30, 2014, the weighted average holdings of RMBS investments based on amortized cost were \$1.352 billion and \$1.359 billion, respectively.

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December 31, 2013:

(\$ in thousands)

	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gross Unrealized		Fair Value	Weighted Average		Weighted Average Life(Years) <sup>(1)</sup>
				Gains	Losses		Coupon	Yield	
Agency RMBS:									
15-year fixed rate mortgages	\$ 179,906	\$ 7,153	\$ 187,059	\$ 65	\$ (3,252 )	\$ 183,872	3.09%	2.52%	5.76
30-year fixed rate mortgages	1,029,629	41,565	1,071,194	490	(28,111 )	1,043,573	3.79%	3.30%	9.80
Adjustable rate mortgages	43,525	2,647	46,172	46	(103 )	46,115	4.72%	3.24%	3.79
Reverse mortgages	7,581	673	8,254	16	(2 )	8,268	4.85%	2.90%	3.41
Interest only securities	n/a	n/a	10,718	2,841	(32 )	13,527	3.97%	11.79%	5.02
Total Agency RMBS	1,260,641	52,038	1,323,397	3,458	(31,500 )	1,295,355	3.75%	3.26%	8.67
Non-Agency RMBS	50,006	(21,327 )	28,679	2,196	(194 )	30,681	2.84%	9.12%	5.54
Total RMBS	\$ 1,310,647	\$ 30,711	\$ 1,352,076	\$ 5,654	\$ (31,694)	\$ 1,326,036	3.72%	3.38%	8.56

Average lives of RMBS are generally shorter than stated contractual maturities. Average lives are affected by the (1) contractual maturities of the underlying mortgages, scheduled periodic payments of principal, and unscheduled prepayments of principal.

For the year ended December 31, 2013, the weighted average holdings of RMBS investments based on amortized cost was \$879.9 million.

By Estimated Weighted Average Life  
As of September 30, 2014:

Estimated Weighted Average Life	Agency RMBS			Agency Interest Only Securities			Non-Agency RMBS		
	Fair Value	Amortized Cost	Weighted Average Coupon	Fair Value	Amortized Cost	Weighted Average Coupon	Fair Value	Amortized Cost	Weighted Average Coupon
Less than three years	\$ 8,216	\$ 8,160	4.85 %	\$ 4,665	\$ 4,930	3.34 %	\$ 3,113	\$ 1,945	3.02 %
Greater than three years and less than seven years	253,354	252,667	3.95 %	9,577	7,178	5.11 %	18,274	18,061	2.66 %
Greater than seven years and less than eleven years	1,058,548	1,052,425	4.01 %	—	—	— %	12,345	11,211	1.24 %
Total	\$ 1,320,118	\$ 1,313,252	4.00 %	\$ 14,242	\$ 12,108	4.19 %	\$ 33,732	\$ 31,217	2.30 %

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As of December 31, 2013:

Estimated Weighted Average Life	Agency RMBS			Agency Interest Only Securities			Non-Agency RMBS				
	Fair Value	Amortized Cost	Weighted Average Coupon	Fair Value	Amortized Cost	Weighted Average Coupon	Fair Value	Amortized Cost	Weighted Average Coupon		
Less than three years	\$5,554	\$5,518	5.68 %	\$955	\$762	6.48 %	\$1,715	\$1,216	2.38 %		
Greater than three years and less than seven years	243,120	246,342	3.48 %	7,643	6,198	3.31 %	16,488	15,950	3.42 %		
Greater than seven years and less than eleven years	1,031,552	1,059,223	3.79 %	4,929	3,758	4.91 %	11,656	10,708	1.43 %		
Greater than eleven years	1,602	1,596	4.50 %	—	—	— %	822	805	7.69 %		
Total	\$1,281,828	\$1,312,679	3.73 %	\$13,527	\$10,718	3.97 %	\$30,681	\$28,679	2.84 %		

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The following table illustrates components of interest income on the Company's RMBS for the three and nine month periods ended September 30, 2014:

(\$ in thousands)	Three Month Period Ended September 30, 2014			Nine Month Period Ended September 30, 2014		
	Coupon Interest	Net Amortization	Interest Income	Coupon Interest	Net Amortization	Interest Income
Agency RMBS	\$13,254	\$(2,575)	\$10,679	\$39,323	\$(6,618)	\$32,705
Non-Agency RMBS	303	502	805	947	1,359	2,306
Total	\$13,557	\$(2,073)	\$11,484	\$40,270	\$(5,259)	\$35,011

The following table illustrates components of interest income on the Company's RMBS for the three and nine month periods ended September 30, 2013:

(\$ in thousands)	Three Month Period Ended September 30, 2013			Nine Month Period Ended September 30, 2013		
	Coupon Interest	Net Amortization	Interest Income	Coupon Interest	Net Amortization	Interest Income
Agency RMBS	\$12,570	\$(2,089)	\$10,481	\$17,484	\$(3,129)	\$14,355
Non-Agency RMBS	428	307	735	824	631	1,455
Total	\$12,998	\$(1,782)	\$11,216	\$18,308	\$(2,498)	\$15,810

#### 4. Valuation

The Company applies ASC 820-10 to its holdings of financial instruments. ASC 820-10 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. Financial instruments include securities and derivatives. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in these securities. The following is a description of the valuation methodologies used for financial instruments:

Level 1—valuation methodologies include the observation of quoted prices (unadjusted) for identical assets or liabilities in active markets, often received from widely recognized data providers.

Level 2—valuation methodologies include the observation of (i) quoted prices for similar assets or liabilities in active markets, (ii) inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves) in active markets and (iii) quoted prices for identical or similar assets or liabilities in markets that are not active.

The Company's Agency RMBS, exclusive of Agency interest only securities, or "Agency IOs," are classified as Level 2 assets. Fair value for Agency RMBS, excluding Agency IOs is determined using inputs considered to be observable including multiple indicative quotes from broker-dealers and recent trading activity for similar securities.

Level 3—valuation methodologies include (i) the solicitation of valuations from third parties (typically, pricing services and broker-dealers), (ii) the use of proprietary models that require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions, and (iii) the assessment of observable or reported recent trading activity. The Company utilizes such information to assign a good faith fair value (the estimated price that would be received to sell an asset or paid to transfer a liability in an orderly transaction at the valuation date) to each such financial instrument.

The Company's non-Agency RMBS and Agency IOs are classified as Level 3 assets.

The Company seeks to obtain at least one third-party indicative valuation for each instrument, and often obtains multiple indicative valuations when available. Third-party valuation providers often utilize proprietary models that are highly subjective and also require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions. The Company has been able to obtain third-party valuations on the vast majority of its assets, and the Company expects to continue to solicit third-party valuations on substantially all of its assets in the future to the extent practical. The Company generally values each financial instrument at the average of third-party valuations received and not rejected as

described below. Third-party valuations are not binding on the Company and while the Company generally does not adjust valuations it receives, it may challenge or reject a valuation when, based on validation

criteria, the Company determines that such valuation is unreasonable or erroneous. Furthermore, the Company may determine, based on validation criteria, that for a given instrument the average of the third-party valuations received does not result in what the Company believes to be fair value, and in such circumstances the Company may override this average with its own good faith valuation. The validation criteria include the use of the Company's own models, recent trading activity in the same or similar instruments, and valuations received from third parties. The Company's valuation process, including the application of validation criteria, is overseen by a valuation committee. Because of the inherent uncertainty of valuation, these estimated values may differ significantly from the values that would have been used had a ready market for the financial instruments existed, and the differences could be material to the consolidated financial statements.

The following tables present the Company's financial instruments measured at fair value on:

September 30, 2014:

(In thousands)

Description	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
<b>Mortgage-backed securities, at fair value:</b>				
<b>Agency RMBS:</b>				
15-year fixed rate mortgages	\$—	\$ 143,357	\$—	\$ 143,357
20-year fixed rate mortgages	—	10,662	—	10,662
30-year fixed rate mortgages	—	1,098,761	—	1,098,761
Adjustable rate mortgages	—	46,121	—	46,121
Reverse mortgages	—	21,217	—	21,217
Interest only securities	—	—	14,242	14,242
Non-Agency RMBS	—	—	33,732	33,732
Mortgage-backed securities, at fair value	—	1,320,118	47,974	1,368,092
<b>Financial derivatives—assets, at fair value:</b>				
TBAs	—	397	—	397
Fixed payer interest rate swaps	—	8,042	—	8,042
Total financial derivatives—assets, at fair value	—	8,439	—	8,439
Reverse repurchase agreements	—	2,484	—	2,484
Total mortgage-backed securities, financial derivatives—assets, and reverse repurchase agreements, at fair value	\$—	\$ 1,331,041	\$ 47,974	\$ 1,379,015
<b>Liabilities:</b>				
U.S. Treasury securities sold short, at fair value	\$—	\$(2,483)	\$—	\$(2,483)
<b>Financial derivatives—liabilities, at fair value:</b>				
TBAs	—	(492)	—	(492)
Fixed payer interest rate swaps	—	(2,333)	—	(2,333)
Fixed payer swaptions	—	(25)	—	(25)
Total financial derivatives—liabilities, at fair value	\$—	\$(2,850)	\$—	\$(2,850)
Total U.S. Treasury securities and financial derivatives—liabilities, at fair value	\$—	\$(5,333)	\$—	\$(5,333)

There were no transfers of financial instruments between Levels 1, 2, or 3 of the fair value hierarchy during the nine month period ended September 30, 2014.

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December 31, 2013:

(In thousands)

Description	Level 1	Level 2	Level 3	Total
Assets:				
Mortgage-backed securities, at fair value:				
Agency RMBS:				
15-year fixed rate mortgages	\$—	\$ 183,872	\$—	\$ 183,872
30-year fixed rate mortgages	—	1,043,573	—	1,043,573
Adjustable rate mortgages	—	46,115	—	46,115
Reverse mortgages	—	8,268	—	8,268
Interest only securities	—	—	13,527	13,527
Non-Agency RMBS	—	—	30,681	30,681
Mortgage-backed securities, at fair value	—	1,281,828	44,208	1,326,036
Financial derivatives—assets, at fair value:				
TBAs	—	2,263	—	2,263
Fixed payer interest rate swaps	—	32,700	—	32,700
Total financial derivatives—assets, at fair value	—	34,963	—	34,963
Total mortgage-backed securities and financial derivatives—assets, at fair value	\$—	\$ 1,316,791	\$ 44,208	\$ 1,360,999
Liabilities:				
Financial derivatives—liabilities, at fair value:				
TBAs	\$—	\$(28)	\$—	\$(28)
Fixed payer interest rate swaps	—	(956)	—	(956)
Fixed payer swaptions	—	(85)	—	(85)
Total financial derivatives—liabilities, at fair value	\$—	\$(1,069)	\$—	\$(1,069)

There were no transfers of financial instruments between Levels 1, 2, or 3 of the fair value hierarchy during the year ended December 31, 2013.

The following tables present additional information about the Company's investments which are measured at fair value for which the Company has utilized Level 3 inputs to determine fair value:

Three month period ended September 30, 2014:

(In thousands)	Non-Agency RMBS	Agency RMBS
Beginning balance as of June 30, 2014	\$ 35,668	\$ 14,276
Transfers:		
Transfers into level 3	—	—
Transfers out of level 3	—	—
Purchases	2,543	545
Proceeds from sales	(3,688)	—
Principal repayments	(1,373)	—
(Amortization)/accretion, net	502	(906)
Net realized gains	1,145	—
Change in net unrealized gains (losses)	(1,065)	327
Ending balance as of September 30, 2014	\$ 33,732	\$ 14,242

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at September 30, 2014, as well as Level 3 financial instruments disposed of by the Company during the three month period ended September 30, 2014. For Level 3 financial instruments held





by the Company at September 30, 2014, change in net unrealized gains (losses) of \$0.3 million and \$(0.1) million, for the three month period ended September 30, 2014 relate to Agency RMBS and non-Agency RMBS, respectively. Three month period ended September 30, 2013:

(In thousands)	Non-Agency RMBS	Agency RMBS
Beginning balance as of June 30, 2013	\$38,810	\$9,905
Transfers:		
Transfers into level 3	—	—
Transfers out of level 3	—	—
Purchases	6,402	3,094
Proceeds from sales	(9,247	) —
Principal repayments	(2,927	) —
(Amortization)/accretion, net	307	(626 )
Net realized gains	581	—
Change in net unrealized gains (losses)	541	349
Ending balance as of September 30, 2013	\$34,467	\$12,722

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at September 30, 2013, as well as Level 3 financial instruments disposed of by the Company during the three month period ended September 30, 2013. For Level 3 financial instruments held by the Company at September 30, 2013, change in net unrealized gains (losses) of \$0.3 million and \$0.7 million, for the three month period ended September 30, 2013 relate to Agency RMBS and non-Agency RMBS.

Nine month period ended September 30, 2014:

(In thousands)	Non-Agency RMBS	Agency RMBS
Beginning balance as of December 31, 2013	\$30,681	\$13,527
Transfers:		
Transfers into level 3	—	—
Transfers out of level 3	—	—
Purchases	14,711	4,640
Proceeds from sales	(11,104	) (1,282 )
Principal repayments	(3,945	) —
(Amortization)/accretion, net	1,359	(2,326 )
Net realized gains	1,518	358
Change in net unrealized gains (losses)	512	(675 )
Ending balance as of September 30, 2014	\$33,732	\$14,242

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at September 30, 2014, as well as Level 3 financial instruments disposed of by the Company during the nine month period ended September 30, 2014. For Level 3 financial instruments held by the Company at September 30, 2014, change in net unrealized gains (losses) of \$(0.5) million and \$0.8 million, for the nine month period ended September 30, 2014 relate to Agency RMBS and non-Agency RMBS, respectively.

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Nine month period ended September 30, 2013:

(In thousands)	Non-Agency RMBS	Agency RMBS
Beginning balance as of December 31, 2012	\$13,596	\$—
Transfers:		
Transfers into level 3	—	—
Transfers out of level 3	—	—
Purchases	37,180	12,116
Proceeds from sales	(14,556)	)
Principal repayments	(4,390)	)
(Amortization)/accretion, net	631	(761)
Net realized gains	1,469	—
Change in net unrealized gains (losses)	537	1,367
Ending balance as of September 30, 2013	\$34,467	\$12,722

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at September 30, 2013, as well as Level 3 financial instruments disposed of by the Company during the nine month period ended September 30, 2013. For Level 3 financial instruments held by the Company at September 30, 2013, change in net unrealized gains (losses) of \$1.4 million and \$0.6 million, for the nine month period ended September 30, 2013 relate to Agency RMBS and non-Agency RMBS, respectively.

The following tables identify the significant unobservable inputs that affect the valuation of the Company's Level 3 assets and liabilities as of September 30, 2014 and December 31, 2013:

September 30, 2014:

Description	Fair Value (In thousands)	Valuation Technique	Significant Unobservable Input	Range		Weighted Average <sup>(1)</sup>	
				Min	Max		
Non-Agency RMBS	\$28,493	Market quotes	Non-Binding Indicative Price	\$46.05	\$106.25	\$76.25	
Non-Agency RMBS	5,239	Discounted Cash Flows	Yield	7.3	% 15.6	% 9.2	%
			Projected Collateral Prepayments	30.8	% 41.7	% 37.1	%
			Projected Collateral Losses	3.9	% 7.2	% 5.5	%
			Projected Collateral Recoveries	5.2	% 10.9	% 8.4	%
			Projected Collateral Scheduled Amortization	46.2	% 53.8	% 49.0	%
Agency RMBS—Interest Only Securities	12,402	Market quotes	Non-Binding Indicative Price	\$4.82	\$21.42	\$14.23	100.0 %
Agency RMBS—Interest Only Securities	1,840	Option Adjusted Spread ("OAS")	LIBOR OAS <sup>(2)</sup>	80	417	224	
				70.2	% 70.9	% 70.5	%

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Projected Collateral Prepayments						
Projected Collateral Scheduled Amortization	29.1	%	29.8	%	29.5	%
					100.0	%

(1) Averages are weighted based on the fair value of the related instrument.

(2) Shown in basis points.

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December 31, 2013:

Description	Fair Value (In thousands)	Valuation Technique	Significant Unobservable Input	Range		Weighted Average <sup>(1)</sup>	
				Min	Max		
Non-Agency RMBS	\$27,422	Market quotes	Non-Binding Indicative Price	\$20.00	\$100.25		\$75.39
Non-Agency RMBS	3,259	Discounted Cash Flows	Yield	6.0	% 17.0	% 11.9	%
			Projected Collateral Prepayments	12.2	% 58.1	% 33.9	%
			Projected Collateral Losses	6.4	% 26.5	% 11.8	%
			Projected Collateral Recoveries	4.6	% 12.8	% 8.8	%
			Projected Collateral Scheduled Amortization	29.9	% 54.9	% 45.5	%
						100.0	%
Agency RMBS–Interest Only Securities	12,368	Market quotes	Non-Binding Indicative Price	\$4.99	\$22.47		\$14.92
Agency RMBS–Interest Only Securities	1,159	Option Adjusted Spread ("OAS")	LIBOR OAS <sup>(2)</sup>	436	436		436
			Projected Collateral Prepayments	57.8	% 57.8	% 57.8	%
			Projected Collateral Scheduled Amortization	42.2	% 42.2	% 42.2	%
						100.0	%

(1) Averages are weighted based on the fair value of the related instrument.

(2) Shown in basis points.

Third-party non-binding indicative prices are validated by comparing such prices to internally generated prices based on the Company's models and to recent trading activity in the same or similar instruments. For those instruments valued using discounted cash flows, collateral prepayments, losses, recoveries, and scheduled amortization are projected over the remaining life of the collateral and expressed as a percentage of the collateral's current principal balance. For those assets valued using the LIBOR Option Adjusted Spread, or "OAS," valuation methodology, cash flows are projected using the Company's models over multiple interest rate scenarios, and these projected cash flows are then discounted using the LIBOR rates implied by each interest rate scenario. The LIBOR OAS of an asset is then computed as the unique constant yield spread that, when added to all LIBOR rates in each interest rate scenario generated by the model, will equate (a) the expected present value of the projected asset cash flows over all model scenarios to (b) the actual current market price of the asset. LIBOR OAS is therefore model-dependent. Generally speaking, LIBOR OAS measures the additional yield spread over LIBOR that an asset provides at its current market price after taking into account any interest rate options embedded in the asset.

Material changes in any of the inputs above in isolation could result in a significant change to reported fair value measurements. Fair value measurements are impacted by the interrelationships of these inputs. For example, a higher expectation of collateral prepayments will generally result in a lower expectation of collateral losses. Conversely, higher losses will generally result in lower prepayments.

## 5. Financial Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. Specifically, the Company's primary source of debt financing is repurchase agreements and the Company enters into financial derivative and other instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates and their related cash flows, the Company may enter into a variety of derivative contracts, including interest rate swaps, interest rate swaptions, and TBAs. Additionally, from time to time, the Company may use short positions in U.S. Treasury securities to hedge its interest rate risk.

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The following table details fair value of the Company's holdings of financial derivatives as of September 30, 2014 and December 31, 2013:

	September 30, 2014 (In thousands)	December 31, 2013
Financial derivatives—assets, at fair value:		
TBA securities purchase contracts	\$28	\$1
TBA securities sale contracts	369	2,262
Fixed payer interest rate swaps	8,042	32,700
Total financial derivatives—assets, at fair value:	\$8,439	\$34,963
Financial derivatives—liabilities, at fair value:		
TBA securities purchase contracts	\$(81	) \$—
TBA securities sale contracts	(411	) (28
Fixed payer interest rate swaps	(2,333	) (956
Swaptions	(25	) (85
Total financial derivatives—liabilities, at fair value:	\$(2,850	) \$(1,069
Total	\$5,589	\$33,894

Interest Rate Swaps

The following tables provide information about the Company's interest rate swaps as of September 30, 2014 and December 31, 2013:

September 30, 2014:

Remaining Maturity	Notional Amount (In thousands)	Fair Value	Weighted Average		Remaining Years to Maturity
			Pay Rate	Receive Rate	
2016	\$48,000	\$(37	) 0.80	% 0.23	% 2.02
2017	74,750	(96	) 1.21	0.24	2.84
2018	33,500	695	0.88	0.24	3.63
2020	43,200	1,313	1.42	0.23	5.62
2021	27,000	(150	) 2.29	0.23	6.77
2023	210,600	5,034	2.13	0.23	8.65
2024	27,700	(340	) 2.74	0.21	9.83
2043	54,500	(119	) 3.15	0.23	28.68
2044	9,820	(591	) 3.48	0.23	29.66
Total	\$529,070	\$5,709	1.91	% 0.23	% 9.08

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December 31, 2013:

Remaining Maturity	Notional Amount (In thousands)	Fair Value	Weighted Average		Remaining Years to Maturity
			Pay Rate	Receive Rate	
2016	\$48,000	\$(171)	0.80	% 0.24	% 2.77
2017	124,000	(517)	1.19	0.24	3.61
2018	156,500	2,784	1.19	0.24	4.63
2020	137,100	6,444	1.49	0.24	6.06
2023	218,000	14,599	2.16	0.24	9.41
2043	64,750	8,605	3.18	0.24	29.44
Total	\$748,350	\$31,744	1.67	% 0.24	% 8.14

The Company uses period end notional values as a percentage of average monthly notional values as an indicator of the volume of activity with respect to financial derivatives. For the nine month period ended September 30, 2014, period end aggregate notional value of interest rate swaps reflected above represents approximately 88% of average monthly notional values during the period. For the year ended December 31, 2013, period end aggregate notional value of interest rate swaps reflected above represents approximately 123% of average monthly notional values during the period.

Interest Rate Swaptions

The following tables provide information about the Company's swaptions as of September 30, 2014 and December 31, 2013.

September 30, 2014:

Option Type	Fair Value	Months to Expiration	Underlying Swap		
			Notional Amount	Term (Years)	Fixed Rate
Straddle	\$(25)	) 9.5	\$9,700	10	3.00%

December 31, 2013:

Option Type	Fair Value	Months to Expiration	Underlying Swap		
			Notional Amount	Term (Years)	Fixed Rate
Fixed Payer	\$(59)	) 8.9	\$22,000	10	3.31%
Straddle	\$(26)	) 9.9	\$8,000	10	3.08%

For the nine month period ended September 30, 2014, period end aggregate notional value of swaptions reflected above represents approximately 41% of average monthly notional values during the period. For the year ended December 31, 2013, period end aggregate notional value of swaptions reflected above represents approximately 268% of average monthly notional values during the period.

TBA's

The Company uses TBAs primarily for hedging purposes, typically in the form of short positions. However, the Company may also invest in TBAs for speculative purposes, including holding long positions. Overall, the Company typically holds a net short position.

The Company transacts in the forward settling To Be Announced MBS ("TBA") market. Pursuant to these TBA transactions, the Company agrees to purchase or sell, for future delivery, Agency RMBS with certain principal and interest terms and certain types of underlying collateral, but the particular Agency RMBS to be delivered is not identified until shortly before the TBA settlement date. TBAs are liquid and have quoted market prices and represent the most actively traded class of MBS. The Company primarily uses TBAs to hedge interest rate risk, typically in the form of short positions. However, from





time to time the Company also invests in TBAs as a means of acquiring additional exposure to Agency RMBS, or for speculative purposes, including holding long positions. Overall, the Company typically holds a net short position. The Company does not generally take delivery of TBAs; rather, it settles the associated receivable and payable with its trading counterparties on a net basis. Transactions with the same counterparty for the same TBA that result in a reduction of the position are treated as extinguished.

As of September 30, 2014 and December 31, 2013, the Company had outstanding contracts to purchase ("long positions") and sell ("short positions") TBA securities as follows:

TBA Securities	September 30, 2014				December 31, 2013			
	Notional Amount <sup>(1)</sup>	Cost Basis <sup>(2)</sup>	Market Value <sup>(3)</sup>	Net Carrying Value <sup>(4)</sup>	Notional Amount <sup>(1)</sup>	Cost Basis <sup>(2)</sup>	Market Value <sup>(3)</sup>	Net Carrying Value <sup>(4)</sup>
(In thousands)								
Purchase contracts:								
Assets	\$19,208	\$19,072	\$19,100	\$28	\$1,600	\$1,725	\$1,726	\$1
Liabilities	32,181	32,567	32,486	(81)	—	—	—	—
Sale contracts:								
Assets	(335,197)	(353,155)	(352,786)	369	(363,078)	(375,524)	(373,262)	2,262
Liabilities	(195,429)	(209,093)	(209,504)	(411)	(16,400)	(17,518)	(17,546)	(28)
Total TBA securities, net	\$(479,237)	\$(510,609)	\$(510,704)	\$(95)	\$(377,878)	\$(391,317)	\$(389,082)	\$2,235

(1) Notional amount represents the principal balance of the underlying Agency RMBS.

(2) Cost basis represents the forward price to be paid for the underlying Agency RMBS.

(3) Market value represents the current market value of the underlying Agency RMBS (on a forward delivery basis) as of period end.

(4) Net carrying value represents the difference between the market value of the TBA contract as of period end and the cost basis and is reported in Financial derivatives-assets at fair value and Financial derivatives-liabilities at fair value on the Consolidated Balance Sheet.

For the nine month period ended September 30, 2014, period end aggregate notional value of TBAs reflected above represents approximately 111% of average monthly notional values during the period. For the year ended December 31, 2013, period end aggregate notional value of TBAs reflected above represents approximately 104% of average monthly notional values during the period.

Gains and losses on the Company's financial derivatives for the three and nine month periods ended September 30, 2014 are summarized in the tables below:

Three Month Period Ended September 30, 2014

Derivative Type	Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) Other Than Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) on Financial Derivatives	Change in Net Unrealized Gains (Losses) on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) Other Than on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) on Financial Derivatives
(In thousands)						
Fixed payer interest rate swaps	\$(678)	\$502	\$(176)	\$(1,475)	\$(10)	\$(1,485)
Swaptions		(935)	(935)		898	898

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TBA <sub>s</sub>		(3,280	)	(3,280	)	2,867	2,867			
Total	\$(678	)	\$(3,713	)	\$(4,391	)	\$(1,475	)	\$3,755	\$2,280

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Nine Month Period Ended September 30, 2014

Derivative Type	Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) Other Than Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) on Financial Derivatives	Change in Net Unrealized Gains (Losses) on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) Other Than on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) on Financial Derivatives
(In thousands)						
Fixed payer interest rate swaps	\$ (5,574 )	\$ 4,013	\$ (1,561 )	\$ (1,315 )	\$ (24,720 )	\$ (26,035 )
Swaptions		(935 )	(935 )		60	60
TBAs		(16,478 )	(16,478 )		(2,330 )	(2,330 )
Futures		19	19		—	—
Total	\$ (5,574 )	\$ (13,381 )	\$ (18,955 )	\$ (1,315 )	\$ (26,990 )	\$ (28,305 )

Gains and losses on the Company's financial derivatives for the three and nine month periods ended September 30, 2013 are summarized in the tables below:

Three Month Period Ended September 30, 2013

Derivative Type	Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) Other Than Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) on Financial Derivatives	Change in Net Unrealized Gains (Losses) on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) Other Than on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) on Financial Derivatives
(In thousands)						
Fixed payer interest rate swaps	\$ 49	\$ 2,451	\$ 2,500	\$ (3,109 )	\$ (1,420 )	\$ (4,529 )
Swaptions		—	—		(86 )	(86 )
TBAs		1,773	1,773		(7,557 )	(7,557 )
Total	\$ 49	\$ 4,224	\$ 4,273	\$ (3,109 )	\$ (9,063 )	\$ (12,172 )

Nine Month Period Ended September 30, 2013

Derivative Type	Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) Other Than Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) on Financial Derivatives	Change in Net Unrealized Gains (Losses) on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) Other Than on Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) on Financial Derivatives
(In thousands)						
Fixed payer interest rate swaps	\$ (20 )	\$ 2,631	\$ 2,611	\$ (4,151 )	\$ 25,819	\$ 21,668
Swaptions		—	—		(86 )	(86 )

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TBA's		10,039	10,039		(5,468	) (5,468	)
Total	\$(20	) \$12,670	\$12,650	\$(4,151	) \$20,265	\$16,114	

As of September 30, 2014, the Company also held a short position in a five-year U.S. Treasury security, with a principal amount of \$2.5 million and a fair value of \$2.5 million.

6. Borrowings under Repurchase Agreements

The Company enters into repurchase agreements. A repurchase agreement involves the sale of an asset to a counterparty together with a simultaneous agreement to repurchase the transferred asset or similar asset from such counterparty at a future date. The Company accounts for its repurchase agreements as collateralized borrowings, with the transferred assets effectively serving as collateral for the related borrowing. The Company's repurchase agreements typically range in term from 30 to 180 days. The principal economic terms of each repurchase agreement—such as loan amount, interest rate, and maturity date—are

typically negotiated on a transaction-by-transaction basis. Other terms and conditions, such as relating to events of default, are typically governed under the Company's master repurchase agreements, or "MRAs." Absent an event of default, the Company maintains beneficial ownership of the transferred securities during the term of the repurchase agreement and receives the related principal and interest payments. Interest rates on these borrowings are generally fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase agreement at which time the Company may enter into a new repurchase agreement at prevailing market rates with the same counterparty, repay that counterparty and possibly negotiate financing terms with a different counterparty, or choose to no longer finance the related asset. In response to a decline in the fair value of the transferred securities, whether as a result of changes in market conditions, security paydowns, or other factors, repurchase agreement counterparties will typically make a margin call, whereby the Company will be required to post additional securities and/or cash as collateral with the counterparty in order to re-establish the agreed-upon collateralization requirements. The contractual amount (loan amount) of the Company's repurchase agreements approximates fair value, as the debt is short-term in nature.

At any given time, the Company seeks to have its outstanding borrowings under repurchase agreements with several different counterparties in order to reduce the exposure to any single counterparty. As of September 30, 2014 and December 31, 2013, the Company had outstanding borrowings under repurchase agreements with ten and nine counterparties, respectively.

The following table details the Company's outstanding borrowings under repurchase agreements as of September 30, 2014 and December 31, 2013:

Remaining Days to Maturity	September 30, 2014			December 31, 2013		
	Borrowings Outstanding	Weighted Average Interest Rate	Remaining Days to Maturity	Borrowings Outstanding	Weighted Average Interest Rate	Remaining Days to Maturity
	(In thousands)					
30 days or less	\$325,079	0.34	% 16	\$338,700	0.35	% 14
31-60 days	519,999	0.33	45	531,799	0.39	46
61-90 days	338,669	0.33	73	326,386	0.38	72
91-120 days	22,192	0.38	106	109,476	0.45	100
121-150 days	27,394	0.38	135	3,986	0.56	136
Total	\$1,233,333	0.33	% 48	\$1,310,347	0.38	% 49

Repurchase agreements involving underlying investments that we sold prior to period end, for settlement following period end, are shown using their original maturity dates even though such repurchase agreements may be expected to be terminated early upon settlement of the sale of the underlying investment. Not included are any repurchase agreements that we may have entered into prior to period end for which delivery of the borrowed funds is not scheduled until after period end.

As of September 30, 2014 and December 31, 2013, the fair value of Agency RMBS transferred as collateral under outstanding borrowings under repurchase agreements was \$1.3 billion and \$1.4 billion, respectively. Collateral transferred under outstanding borrowings as of September 30, 2014 include Agency RMBS in the amount of \$10.0 million that were sold prior to period end but for which such sale had not yet settled. Collateral transferred under outstanding borrowings as of December 31, 2013 include Agency RMBS in the amount of \$76.1 million that were sold prior to period end but for which such sale had not yet settled. In addition the Company posted net cash collateral of \$11.5 million and additional securities with a fair value of \$1.8 million as of September 30, 2014 as a result of margin calls with various counterparties. The Company posted additional net cash collateral of \$14.8 million and additional securities with a fair value of \$3.5 million as of December 31, 2013 as a result of margin calls with various counterparties. The Company also held investments with an aggregate value of approximately \$0.5 million which were received to satisfy collateral requirements for various repurchase agreements.

#### 7. Offsetting of Assets and Liabilities

The Company records financial instruments at fair value as described in Note 4. All financial instruments are recorded on a gross basis on the Consolidated Balance Sheet. In connection with its financial derivatives, repurchase agreements, and related trading agreements, the Company and its counterparties are required to pledge collateral. Cash or other collateral is exchanged as required with each of the Company's counterparties in connection with open derivative positions and repurchase agreements.

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The following tables present information about certain assets and liabilities representing financial instruments as of September 30, 2014 and December 31, 2013. The Company has not previously entered into master netting agreements with any of its counterparties. Certain of the Company's repurchase and reverse repurchase agreements and financial derivative transactions are governed by underlying agreements that generally provide a right of offset in the event of default or in the event of a bankruptcy of either party to the transaction.

September 30, 2014:

Description	Amount of Assets (Liabilities) Presented in the Consolidated Balance Sheet <sup>(1)</sup>	Financial Instruments Available for Offset	Financial Instruments Transferred or Pledged as Collateral <sup>(2)(3)</sup>	Cash Collateral (Received) Pledged <sup>(2)(3)</sup>	Net Amount
(In thousands)					
Assets:					
Financial derivatives—assets	\$8,439	\$(628 )	\$—	\$(2,411 )	\$5,400
Reverse repurchase agreements	2,484	(2,484 )	—	—	—
Liabilities:					
Financial derivatives—liabilities	(2,850 )	628	—	2,054	(168 )
Repurchase agreements	(1,233,333 )	2,484	1,219,354	11,495	—

(1) In the Company's Consolidated Balance Sheet, all balances associated with the repurchase agreements and financial derivatives are presented on a gross basis.

For the purpose of this presentation, for each row the total amount of financial instruments transferred or pledged and cash collateral (received) or pledged may not exceed the applicable gross amount of assets or (liabilities) as presented here. Therefore, we have reduced the amount of financial instruments transferred or pledged as collateral

(2) related to our repurchase agreements and cash collateral pledged on our financial derivative assets and liabilities.

Total financial instruments transferred or pledged as collateral on our repurchase agreements as of September 30, 2014 were \$1.28 billion. As of September 30, 2014 total cash collateral on financial derivative assets and financial derivative liabilities excludes \$20.5 thousand and \$5.1 million of net excess cash collateral.

(3) When collateral is pledged to or pledged by a counterparty, it is often pledged or posted with respect to all positions with such counterparty, and in such cases such collateral cannot be specifically identified as relating to a specific asset or liability. As a result, in preparing the above table, the Company has made assumptions in allocating pledged or posted collateral among the various rows.

December 31, 2013:

Description	Amount of Assets (Liabilities) Presented in the Consolidated Balance Sheet <sup>(1)</sup>	Financial Instruments Available for Offset	Financial Instruments Transferred or Pledged as Collateral <sup>(2)(3)</sup>	Cash Collateral (Received) Pledged <sup>(2)(3)</sup>	Net Amount
(In thousands)					
Assets:					
Financial derivatives—assets	\$34,963	\$(1,042 )	\$—	\$(22,360 )	\$11,561
Liabilities:					
Financial derivatives—liabilities	(1,069 )	1,042	—	26	(1 )
Repurchase agreements	(1,310,347 )	—	1,295,567	14,780	—

(1) In the Company's Consolidated Balance Sheet, all balances associated with the repurchase agreements and financial derivatives are presented on a gross basis.

(2) For the purpose of this presentation, for each row the total amount of financial instruments transferred or pledged and cash collateral (received) or pledged may not exceed the applicable gross amount of assets or (liabilities) as presented here. Therefore we have reduced the amount of financial instruments transferred or pledged as collateral related to our repurchase agreements and cash collateral pledged on our financial derivative assets and liabilities.



Total financial instruments transferred or pledged as collateral on our repurchase agreements as of December 31, 2013 were \$1.36 billion. As of December 31, 2013 total cash collateral on financial derivative assets and liabilities excludes \$0.3 million and \$3.1 million, respectively of net excess cash collateral.

(3) When collateral is pledged to or pledged by a counterparty, it is often pledged or posted with respect to all positions with such counterparty, and in such cases such collateral cannot be specifically identified as relating to a specific asset or liability. As a result, in preparing the above table, the Company has made assumptions in allocating pledged or posted collateral among the various rows.

#### 8. Management Fees

The Manager receives an annual management fee in an amount equal to 1.50% per annum of shareholders' equity (as defined in the Management Agreement) as of the end of each fiscal quarter (before deductions for any management fee with respect to such fiscal period). The management fee is payable quarterly in arrears. For both of the three month periods ended

September 30, 2014 and 2013, the total management fee incurred was approximately \$0.6 million. For the nine month periods ended September 30, 2014 and 2013, the total management fee incurred was approximately \$1.7 million and \$1.5 million, respectively.

Shareholders' equity is defined in the Management Agreement, as of the end of any fiscal quarter, as (a) the sum of (1) the net proceeds from any issuances of common shares or other equity securities of the Company or the Operating Partnership (without double counting) since inception, plus (2) the Company's and the Operating Partnership's (without double counting) retained earnings or accumulated deficit calculated in accordance with U.S. GAAP at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less (b) any amount that the Company or the Operating Partnership has paid to repurchase common shares, limited partnership interests in the Operating Partnership or other equity securities since inception. Shareholders' equity excludes (1) any unrealized gains, losses, or non-cash equity compensation expenses that have impacted shareholders' equity as reported in the financial statements prepared in accordance with U.S. GAAP, regardless of whether such items are included in net income, and (2) one-time events pursuant to changes in U.S. GAAP, and certain non-cash items not otherwise described above, in each case, after discussions between the Manager and the Company's independent trustees and approval by a majority of the Company's independent trustees.

#### 9. Earnings Per Share

Basic earnings per share, or "EPS," is calculated by dividing net income (loss) for the period by the weighted average of the Company's common shares outstanding for the period. Diluted EPS takes into account the effect of outstanding dilutive instruments, such as share options and warrants, if any, and uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted average number of shares outstanding. As of September 30, 2014 and 2013, the Company did not have any dilutive instruments outstanding.

The following table presents a reconciliation of the earnings/(losses) and shares used in calculating basic EPS for the three and nine month periods ended September 30, 2014 and 2013:

(In thousands except share amounts)	Three Month Period Ended September 30, 2014	Three Month Period Ended September 30, 2013	Nine Month Period Ended September 30, 2014	Nine Month Period Ended September 30, 2013
Numerator:				
Net income (loss)	\$3,533	\$6,785	\$17,344	\$(1,789 )
Denominator:				
Basic and diluted weighted average shares outstanding	9,141,892	9,133,940	9,140,533	5,699,501
Basic and Diluted Earnings Per Share	\$0.39	\$0.74	\$1.90	\$(0.31 )

#### 10. Related Party Transactions

##### Management Agreement

The Company has entered into a management agreement with the Manager, which provides for an initial term through September 24, 2017, and which will be renewed automatically each year thereafter for an additional one-year period, subject to certain termination rights. The Company is externally managed and advised by the Manager. Pursuant to the terms of the Management Agreement, effective March 13, 2014, the Manager provides the Company with its management team, including its officers and appropriate support personnel. The Company does not have any employees. The Manager is responsible for the day-to-day operations of the Company.

##### Services Agreement

The Manager and EMG are parties to a services agreement, pursuant to which EMG is required to provide to the Manager sufficient personnel, services, and resources to enable the Manager to carry out its obligations and responsibilities under the Management Agreement. The Company is a named third-party beneficiary to the services agreement and, as a result, has, as a non-exclusive remedy, a direct right of action against EMG in the event of any breach by the Manager of any of its duties, obligations, or agreements under the Management Agreement that arise out of or result from any breach by EMG of its obligations under the services agreement. The services agreement will terminate upon the termination of the Management Agreement. Pursuant to the services agreement, the Manager

makes certain payments to EMG in connection with the services provided. The Manager and EMG are under common ownership and control. As a result, all management fee compensation earned by the Manager and all service agreement fees earned by EMG accrue to the common benefit of the owners of the

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Manager and EMG, other than in respect of certain special non-voting membership interests in Ellington Residential Mortgage Management LLC held by certain shareholders of the Company.

#### Expense Reimbursement

Under the terms of the Management Agreement the Company is required to reimburse the Manager for operating expenses related to the Company that are incurred by the Manager, including expenses relating to legal, accounting, due diligence, other services, and all other costs and expenses. The Company's reimbursement obligation is not subject to any dollar limitation. Expenses will be reimbursed in cash within 60 days following delivery of the expense statement by the Manager; provided, however, that such reimbursement may be offset by the Manager against amounts due to the Company from the Manager. The Company will not reimburse the Manager for the salaries and other compensation of the Manager's personnel except that the Company will be responsible for expenses incurred by the Manager in employing certain dedicated or partially dedicated personnel as further described below.

The Company reimburses the Manager for the allocable share of the compensation, including, without limitation, wages, salaries, and employee benefits paid or reimbursed, as approved by the Compensation Committee of the Board of Trustees, to certain dedicated or partially dedicated personnel who spend all or a portion of their time managing the Company's affairs, based upon the percentage of time devoted by such personnel to the Company's affairs. In their capacities as officers or personnel of the Manager or its affiliates, such personnel will devote such portion of their time to the Company's affairs as is necessary to enable the Company to operate its business.

For both of the nine month periods ended September 30, 2014 and 2013, the Company reimbursed the Manager \$1.9 million for previously incurred operating and compensation expenses.

#### Termination Fee

The Management Agreement requires the Company to pay a termination fee to the Manager in the event of (1) the Company's termination or non-renewal of the Management Agreement without cause or (2) the Manager's termination of the Management Agreement upon a default by the Company in the performance of any material term of the Management Agreement. Such termination fee will be equal to 5% of Shareholders' Equity, as defined in the Management Agreement (see Note 8 above) as of the month-end preceding termination.

#### Registration Rights Agreement

The Company is a party to a registration rights agreement with an affiliate of EMG and with the Blackstone Tactical Opportunities Funds (the "Blackstone Funds") pursuant to which the Company has granted its initial investors and each of their permitted transferees and other holders of the Company's "registrable common shares" (as such term is defined in the registration rights agreement) who become parties to the registration rights agreement with certain demand and/or piggy-back registration and shelf takedown rights.

#### 11. Capital

The Company has authorized 500,000,000 common shares, \$0.01 par value per share, and 100,000,000 preferred shares, \$0.01 par value per share. The Board of Trustees may authorize the issuance of additional shares of either class. As of September 30, 2014 and December 31, 2013, there were 9,149,274 and 9,139,842 common shares outstanding, respectively. No preferred shares have been issued.

On September 11, 2014, the Company's Board of Trustees authorized the issuance of 9,432 shares to its independent trustees pursuant to director share award agreements. Of these shares 6,912 will vest and become non-forfeitable on September 10, 2015; the remaining 2,520 shares vested on the date of grant.

The below table details cash dividends declared by the Board of Trustees during the nine month period ended September 30, 2014:

	Dividend Per Share	Dividend Amount (In thousands)	Declaration Date	Record Date	Payment Date
First Quarter	\$0.55	\$5,027	March 12, 2014	March 31, 2014	April 28, 2014
Second Quarter	\$0.55	\$5,027	June 17, 2014	June 30, 2014	July 25, 2014
Third Quarter	\$0.55	\$5,032	September 11, 2014	September 30, 2014	October 27, 2014



The below table details cash dividends declared by the Board of Trustees during the nine month period ended September 30, 2013:

	Dividend Per Share	Dividend Amount (In thousands)	Declaration Date	Record Date	Payment Date
Second Quarter	\$0.14	\$1,279	June 18, 2013	June 28, 2013	July 26, 2013
Third Quarter	\$0.50	\$4,569	September 17, 2013	September 27, 2013	October 25, 2013

The Board of Trustees did not declare any cash dividends prior to the second quarter of 2013.

On August 13, 2013, the Company's Board of Trustees approved the adoption of a \$10 million share repurchase program. The program, which is open-ended in duration, allows the Company to make repurchases from time to time on the open market or in negotiated transactions. Repurchases are at the Company's discretion, subject to applicable law, share availability, price and the Company's financial performance, among other considerations. No purchases have been made under the program to date.

#### Distribution Policy

The timing and frequency of distributions will be determined by the Board of Trustees based upon a variety of factors deemed relevant by the Company's trustees, including restrictions under applicable law, capital requirements of the Company, and the REIT requirements of the Code. Distributions to shareholders generally will be taxable as ordinary income, although a portion of such distributions may be designated as long-term capital gain or qualified dividend income, or may constitute a return of capital. The Company will furnish annually to each shareholder a statement setting forth distributions paid during the preceding year and their U.S. federal income tax treatment.

It is the intention of the Company to distribute at least 100% of its taxable income, after application of available tax attributes, within the limits prescribed by the Internal Revenue Code, which may extend into the subsequent taxable year.

#### 12. Commitments and Contingencies

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any significant contingencies at September 30, 2014.

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

In this Quarterly Report on Form 10-Q, except where the context suggests otherwise, "EARN," "we," "us," and "our" refer to Ellington Residential Mortgage REIT and its subsidiaries, our "Manager" refers to Ellington Residential Mortgage Management LLC, our external manager, and "Ellington" refers to Ellington Management Group, L.L.C. and its affiliated investment advisory firms.

### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

When used in this quarterly report on Form 10-Q, in future filings with the Securities and Exchange Commission ("SEC") or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as "believe," "expect," "anticipate," "estimate," "project," "plan," "continue," "intend," "should," "would," "could," "goal," "objective," "will," "may," "seek" or similar expressions, are intended to identify "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and, as such, may involve known and unknown risks, uncertainties, and assumptions.

Forward-looking statements are based on our beliefs, assumptions, and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. The following factors are examples of those that could cause actual results to vary from our forward-looking statements: changes in interest rates and the market value of our securities; our use and dependence on leverage; the impact of Fannie Mae and Freddie Mac being placed into conservatorship and related events, including the lack of certainty as to the future roles and structures of these entities and changes to legislation and regulations affecting these entities; market volatility; changes in the prepayment rates on the mortgage loans underlying the securities we own and intend to acquire; changes in rates of default and/or recovery rates on our non-agency assets; our ability to borrow to finance our assets and the costs of such borrowings; changes in government regulations affecting our business; our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended (the "Investment Company Act"); and risks associated with investing in real estate related assets, including changes in business conditions and the general economy. These and other risks, uncertainties and factors, including the risk factors described under Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 as filed with the SEC, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements speak only as of the date on which they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

### Executive Summary

We are a Maryland real estate investment trust, or "REIT," formed in August 2012 that specializes in acquiring, investing in, and managing residential mortgage- and real estate-related assets. Our primary objective is to generate attractive current yields and risk-adjusted total returns for our shareholders by making investments that we believe compensate us appropriately for the risks associated with them. We seek to attain this objective by constructing and actively managing a portfolio comprised primarily of Agency residential mortgage-backed securities, or "RMBS," and, to a lesser extent, non-Agency RMBS. We also may opportunistically acquire and manage other types of residential mortgage-related and real estate-related asset classes, such as residential mortgage loans, and mortgage servicing rights, or "MSRs." We believe that being able to combine Agency RMBS with non-Agency RMBS and other residential mortgage- and real estate-related asset classes enables us to balance a range of mortgage-related risks. We were formed through an initial strategic venture among affiliates of Ellington, an investment management firm and registered investment adviser with a 19-year history of investing in a broad spectrum of mortgage-backed securities and related derivatives, with an emphasis on the RMBS market, and the Blackstone Tactical Opportunity Funds, or the "Blackstone Funds." These initial investors made an aggregate investment of approximately \$31.5 million on September 25, 2012. On May 1, 2013, we priced an initial public offering of our common shares, pursuant to which we sold 6,450,000 shares to the public at a price of \$20.00 per share. Concurrent with the initial public offering, we completed a private placement of 1,050,000 common shares to our initial investors at a purchase price of

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\$20.00 per share which generated gross proceeds of \$21.0 million. Total gross proceeds to us from the initial public offering and concurrent private placement were \$150.0 million. Proceeds to us, net of offering costs, were approximately \$148.5 million.

We are externally managed and advised by our Manager, an affiliate of Ellington.

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We use leverage in our Agency RMBS strategy and, while we have not done so to date, we may use leverage in our non-Agency RMBS strategy as well, although we expect such leverage to be lower. We have financed our purchases of Agency RMBS exclusively through repurchase agreements, which we account for as collateralized borrowings. As of September 30, 2014, we had outstanding borrowings under repurchase agreements in the amount of \$1.2 billion with ten counterparties.

We made an election to be taxed as a corporation effective as of May 1, 2013 and beginning with our short taxable year May 1, 2013 through December 31, 2013, we elected to be taxed as a REIT for U.S. federal income tax purposes. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income that we distribute currently to our shareholders as long as we maintain our intended qualification as a REIT. We intend to conduct our operations so that neither we nor any of our subsidiaries is required to register as an investment company under the Investment Company Act of 1940, as amended.

As of September 30, 2014, our book value per share was \$18.53 as compared \$18.71 and \$18.29 as of June 30, 2014 and December 31, 2013, respectively.

#### Trends and Recent Market Developments

Key trends and recent market developments for the mortgage-backed security, or "MBS," market include the following:

**Federal Reserve and Monetary Policy**—After measured monthly reductions in net asset purchases, the U.S. Federal Reserve, or "Federal Reserve," concluded its quantitative easing purchase program at the end of October 2014, but also announced that it will continue to reinvest principal payments from existing holdings;

**Housing and Mortgage Market Statistics**—Data released by S&P Indices for its S&P/Case-Shiller Home Price Indices for August 2014 showed, consistent with recent months, that the pace of home price appreciation slowed; meanwhile the Freddie Mac survey 30-year mortgage rate ended the third quarter at 4.20% up slightly from 4.14% at June 30, 2014. Subsequent to quarter-end, the Freddie Mac survey 30-year mortgage rate fell to 3.92% as of October 23, 2014;

**Prepayment Rate Trends**—Prepayments decreased marginally during the third quarter, and increased significantly in October 2014, but remain low given the level of mortgage rates;

**Government Sponsored Enterprise, or "GSE," Developments**—On October 20, 2014, Federal Housing Finance Agency, or "FHFA," Director Mel Watt provided additional clarity on the GSEs' representation and warranty framework, and also indicated that the GSEs will soon increase the maximum loan-to-value, or "LTV," of loans the agencies guarantee to 97% from 95%. Further details will be provided by the GSEs in the coming weeks, but both announcements support Watt's goal of expanding mortgage credit availability. While several proposals have been put forth to replace or eliminate the GSEs or materially revise their current roles in the U.S. mortgage market, no definitive legislation has yet been enacted;

**Bank Regulatory Capital**—Proposed changes will increase regulatory capital requirements for the largest, most systemically significant U.S. banks and their holding companies; while these changes could ultimately alter these institutions' appetite for various risk-taking activities, and could ultimately affect the terms and availability of our repo financing, thus far repo financing has remained readily available and in fact, competition among banks and other lending institutions to provide repo financing has actually increased;

**Portfolio Overview and Outlook**—Prices of Agency RMBS were generally lower in the third quarter, although specified pools performed better than their generic pool (TBA) counterparts. Non-Agency valuations remained strong in the quarter and continued to be supported by overall positive trends in home prices as well as a declining level of foreclosure inventory.

#### Federal Reserve and Monetary Policy

Since December 2013, the Federal Reserve has announced eight incremental reductions in its purchases of Agency RMBS and U.S. Treasury securities under its accommodative monetary policies, concluding its purchase program at the end of October 2014. Prior to these "taper" announcements, and since September 2012, the Federal Reserve had been purchasing long-dated U.S. Treasury securities and Agency RMBS assets at the pace of \$85 billion per month, comprised of \$45 billion of U.S. Treasury securities and \$40 billion of Agency RMBS. The Federal Reserve has announced that it will continue to reinvest principal payments from its holdings into additional asset purchases.

In its October 2014 statement, in addition to announcing the end of its monthly asset purchase programs, the Federal Open Market Committee, or "FOMC," reiterated its intention to maintain the target range for the federal funds rate at

0% to 0.25%. The FOMC also indicated that it continues to anticipate, based on its assessment of labor market conditions, inflationary pressures and expectations, and other factors that it will likely maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends. While the Federal Reserve indicated that its expectations for forward

rates are slightly higher than in prior meetings, they also reiterated language that the overnight Federal Funds target rate will remain close to zero for a "considerable period," allaying concerns that the Federal Reserve could hike rates as soon as the first quarter of 2015.

Since the Federal Reserve's initial taper announcement in December 2013, long-term interest rates have generally declined. As of September 30, 2014, the 10-year U.S. Treasury yield was 2.49% as compared to 2.53% as of June 30, 2014 and 3.03% as of December 31, 2013. Subsequent to quarter end, the 10-year U.S. Treasury yield fell briefly below 2% on October 15, 2014, and was 2.32% as of October 29, 2014. Prices of Agency RMBS have also rallied over the course of the year. For example, the price of TBA 30-year Fannie Mae 3.5s, a widely traded Agency RMBS, was 102.28 as of September 30, 2014, as compared to 102.78 at June 30, 2014 and 99.34 as of December 31, 2013. Notwithstanding the recent decline in interest rates, we believe that there remains substantial risk that interest rates could begin to rise again. Market speculation has shifted from the tapering of asset purchases by the Federal Reserve to the timing of a tightening of monetary policy through, for example, interest rate increases, driven by employment and economic growth in the United States. This reinforces the importance of our ability, subject to our qualifying and maintaining our qualification as a REIT, to hedge interest rate risk in both our Agency and non-Agency RMBS portfolios using a variety of tools, including TBAs, interest rate swaps, and various other instruments.

#### Housing and Mortgage Market Statistics

The following table demonstrates the decline in residential mortgage delinquencies and foreclosure inventory on a national level, as reported by CoreLogic in its September 2014 National Foreclosure Report:

	As of	
Number of Units (In thousands)	September 2014	September 2013
Seriously Delinquent Mortgages <sup>(1)</sup>	1,634	2,077
Foreclosure Inventory	607	924

(1) Seriously Delinquent Mortgages are ninety days and over in delinquency and include foreclosures and real estate owned, or "REO," property.

As the above table indicates, both the number of seriously delinquent mortgages and the number of homes in foreclosure have declined significantly over the past year. This decline supports the thesis that as many homeowners have re-established equity in their homes through recovering real estate prices, they have become less likely to become delinquent and default on their mortgages.

Monthly housing starts provide another indicator of market fundamentals. The following table shows the trailing three-month average housing starts for the periods referenced:

	September 2014	June 2014	September 2013
Single-family <sup>(1)</sup>	646	625	598
Multi-family <sup>(1)</sup>	360	347	270

(1) Shown in thousands of units:

Source: U.S. Census Bureau

As of September 2014, average single-family housing starts during the trailing three months rose 3.4% as compared to June 2014, to 646,000 units. Multi-family housing starts increased by 3.7% during the same period. On a year-over-year basis, while multi-family housing starts during the trailing three months increased by approximately 33% from September 2013, single-family housing starts increased by 8.0%, as continuing tight residential mortgage loan underwriting standards have likely impacted demand for new single-family homes. Even though home prices have recovered meaningfully over the last few years, this recovery has not translated into significant growth in single-family housing starts. This suggests that the recovery in home prices may have been driven more by the active purchase of foreclosure inventory by institutional investors, as opposed to by an increase in demand for traditional owner-occupied single-family housing. In addition, continuing tight mortgage loan underwriting standards are likely part of the cause of this weakness in single-family housing starts.

Data released by S&P Indices for its S&P/Case-Shiller Home Price Indices for August 2014 showed that, on average, home prices had increased from August 2013 by 5.5% and 5.6% for its 10- and 20-City Composites, respectively. The home price indices have flattened out in 2014, suggesting that the pace of home price appreciation in 2013 will likely not be repeated this year. Compared to December 2013, the 10- and 20-City Composites increased 4.7% and 4.8%, respectively. According to the report, home prices remain below the peak levels of 2006, but, on average, are back to

their autumn 2004 levels for both the 10- and 20-City Composites. Finally, as indicated in the table above, as of September 2014, the national inventory of foreclosed homes fell to 607,000 units, a 34% decline when compared to September 2013; this represented the thirty-fifth consecutive

month with a year-over-year decline and the lowest level since November 2008. As a result, there are much fewer unsold foreclosed homes overhanging the housing market than there were a year ago. We believe that near-term home price trends are more likely to be driven by fundamental factors such as economic growth, mortgage rates, and affordability, rather than by technical factors such as shadow inventory. Shadow inventory represents the number of properties that are seriously delinquent, in foreclosure, or held as REO by mortgage servicers, but not currently listed on multiple listing services.

On November 7, 2014, the U.S. Bureau of Labor Statistics, or "BLS," reported that, as of October 2014 the U.S. unemployment rate declined to 5.8%. Another, perhaps more relevant, measure of labor market conditions is employment growth, which has been relatively robust in recent months. The BLS also reported that non-farm payrolls rose by 214,000 during October, a level that is considered reflective of improving labor market conditions. While it is difficult to quantify the relationship between employment data and the housing and mortgage markets, we believe that current levels of unemployment and job creation no longer represent a significant impediment to a continuing housing recovery. However, the continued recovery of the housing market, while supported by still-historically-low mortgage rates and the momentum of improving home prices, faces a number of potential headwinds. These include volatility in interest rates, the sluggish rate of growth in housing starts and new loan origination, and the uneven pace of the recovery of the U.S. economy.

#### Prepayment Rate Trends

The relatively muted level of prepayment activity as interest rates broadly declined in recent years has in large part been the result of: (i) home price declines during the financial crisis, which has left many borrowers with minimal or negative home equity; (ii) more restrictive underwriting guidelines, even for refinancings; and (iii) increased origination costs, especially related to underwriting and compliance. These factors have resulted in substantial variations in prepayment rates between Agency pools as a function of LTV ratio, loan balance, credit score, geography, property type, loan purpose, and other factors. In recognition of the importance of these underlying characteristics on prepayment behavior, the MBS market continues to promote the creation of "specified" Agency pools that emphasize or de-emphasize many of these characteristics, such as pools where the principal balance of every underlying mortgage loan is below \$85,000. The Making Homes Affordable, or "MHA," refinancing program, which was initiated in response to the housing market crisis, has facilitated the origination of many of these kinds of specified Agency pools. The extension of the MHA refinancing program into 2015 should sustain creation of such pools in the coming years. We expect that the ongoing origination of Agency pools with a wide variety of loan characteristics will continue to create opportunities for us to exploit the resulting differences in prepayments.

The Freddie Mac survey 30-year fixed mortgage rate ended the third quarter at 4.20%, reflecting a six basis point increase from the end of the second quarter. Subsequent to the end of the third quarter, the rate fell to 3.92% as of October 23, 2014. The Refinance Index published by the Mortgage Bankers Association, or "MBA," fell approximately 2.3% over the third quarter on a seasonally adjusted basis, but increased 32.6% from the end of the third quarter through October 24, 2014. Similarly the MBA's Market Composite Index, a measure of mortgage application volume, fell 2.7% over the third quarter on a seasonally adjusted basis, but increased 14.3% from the end of the third quarter through October 24, 2014.

The table below illustrates the relationship between the Freddie Mac survey 30-year fixed mortgage rate and the MBA Refinance Index since September 2012. Generally speaking, over the period September 2012 through September 2013, mortgage rates and the level of refinancing activity were nearly linearly correlated. However, following September 2013 and through September 2014, there has been a decoupling of these two time series. As the figure below shows, by September 2014 the MBA Refinance Index was meaningfully lower than one might have expected given the nearly linear relationship that had existed between the two indices from September 2012 and September 2013. However, the increase in refinancings in October 2014 clearly reflects the decline in average mortgage rates during the same period.

#### GSE Developments

On October 20, 2014, Mel Watt, Director of the FHFA, delivered a speech providing additional clarity on the GSE's representation and warranty framework, largely focused on the criteria for life-of-loan exclusions that enable the GSEs to force originators to repurchase loans on account of fraud or non-compliance even after the 36-month window for identifying flawed loans has expired. Additionally, Watt indicated that the GSEs would soon increase maximum LTV ratios from 95% to 97%, with the intent of responsibly expanding credit to lower-down payment borrowers. Further details on both policies are expected in the coming weeks. Previously, on May 13, 2014, Watt presented the FHFA's 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac, or the "Strategic Plan," and the 2014 Conservatorship Scorecard for Fannie Mae and Freddie Mac. The Strategic Plan outlines the FHFA's broader plan to clarify and refine representation and warranty guidelines. Examples offered by Watt include the GSE's relaxation of payment history requirements and elimination of automatic repurchases when mortgage insurance is rescinded. Reflective of his tendency to favor policies that promote affordability through expanded credit, Watt announced that the FHFA will maintain conforming loan limits for GSEs rather than implementing the reductions that were proposed in late 2013 by former FHFA director Ed DeMarco. Credit risk transfers to private investors, which increase capital flows while reducing taxpayer risk, are to grow to \$90 billion per agency, triple the amount required in 2013. The FHFA continues to re-evaluate the implementation of DeMarco's proposed initiative to raise guarantee fees, or "g-fees," on new Fannie Mae and Freddie Mac business. G-fees are the fees charged by the GSEs to include mortgage loans in Agency pools, and thereby insure the mortgage loan against loss. Since these fees are passed on to borrowers whose loans are originated for inclusion in Agency pools, increased g-fees have the effect of reducing housing affordability for GSE borrowers, but potentially make it more attractive for private lenders to replace the GSEs. Decreased expectations of g-fee increases are suggestive of potentially faster prepayment speeds.

Under Watt, the FHFA has reinvigorated the Home Affordable Finance Program, or "HARP," outreach effort by hosting town hall-style meetings in areas with high concentrations of borrowers eligible for the program, which targets high LTV loans owned or guaranteed by GSEs. We believe this may result in only marginally higher prepayments for higher coupon loans to pre-HARP borrowers.

To date, no definitive legislation has been enacted with respect to a possible unwinding of the GSEs or a material reduction in their roles in the U.S. mortgage market. There have been several proposals offered by members of Congress, including the Corker-Warner bill introduced in June 2013, the Johnson-Crapo bill introduced in March 2014, and the Partnership to Strengthen Homeownership Act, which was introduced in July 2014. Though it appears unlikely that one of these bills will be passed in its current form, features may be incorporated into future proposals.

#### Bank Regulatory Capital Changes

Upcoming changes in banking regulations could impact MBS and ABS pricing, as well as the availability and cost of financing of MBS and ABS assets. The Federal Reserve's current implementation of the Basel III rules on bank Supplementary Leverage Ratios, or "SLRs," will significantly curtail the extent to which banks will be permitted to net certain repo and reverse repo agreements against each other when calculating their capital requirements. In addition, rules recently adopted by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency will require the largest U.S. bank holding companies to hold capital equal to 5% of total assets, thus going beyond the 3% minimum set by Basel III rules. As a consequence, in an effort to maximize return on equity, banks may be incentivized to reduce their repo financing operations, especially for lower-profit-margin financings such as those involving U.S. Treasury securities and Agency RMBS. U.S. banking regulators also released a notice of proposed rulemaking outlining some minor changes to the SLR rules that would make the U.S. SLR definitions more similar to those currently used in Europe. In particular, these proposed rules would result in slightly more stringent capital treatment of repo lending activities. In addition, full implementation of Basel III regulations, in particular the carve-out rules related to accumulated other comprehensive income, or "AOCI," are likely to reduce bank demand for assets with higher duration, and as a result could hurt the liquidity of the tradable MBS market. Under the AOCI carve-out rules, banks with more than \$250 billion in assets will be required to include mark-to-market gains and losses on available-for-sale, or "AFS," securities when calculating their Tier 1 capital. This incentivizes banks to classify Agency RMBS as held-to-maturity and other illiquid assets, effectively locking more bank-held Agency RMBS out of the tradable market, and thus reducing market liquidity. In addition, banks will likely want to reduce the risk of their AFS securities holdings, which will incentivize them to hold lower duration assets such as 15-year Agency RMBS. While our access to repo financing continues to not be negatively impacted, it is still possible that certain of our lending institutions could, in the future, decide to curtail their repo lending activities in response to these developments, particularly in connection with repo financing on Agency RMBS. However, it is also possible that these changes will create opportunities for smaller banks and/or non-bank lenders to enter the repo financing market, and in fact we continue to see smaller broker-dealers becoming more active in the Agency pool repo financing market.

#### Portfolio Overview and Outlook

##### Agency

As of September 30, 2014, the value of our long Agency portfolio was \$1.334 billion, as compared to \$1.309 billion as of June 30, 2014, representing an increase of 2.0%.

Our Agency RMBS portfolio is principally comprised of "specified pools." Specified pools are fixed rate Agency pools with special prepayment characteristics, such as pools comprised of low loan balance mortgages, pools comprised of mortgages backed by investor properties, pools containing mortgages originated through the government-sponsored "Making Homes Affordable" refinancing programs, and pools containing mortgages with various other prepayment characteristics. During the third quarter, our Agency RMBS purchasing activity continued to focus primarily on specified pools, especially those with higher coupons.

As anticipated, the Federal Reserve continued to taper its monthly purchases of Agency RMBS and U.S. Treasury securities. The Federal Reserve concluded its monthly bond purchases at the end of October, but expects to continue to reinvest paydown proceeds from its held portfolio into additional Agency RMBS and U.S. Treasury securities. As the Federal Reserve's market dominance continues to decline, we believe additional opportunities will be created for us and other private investors.

During the third quarter, specified pools outperformed their TBA counterparts, notwithstanding the fact that Agency RMBS prepayment speeds remained low by historical standards. Contributing to the third quarter outperformance of specified pools was the Federal Reserve's continued reduction in its Agency RMBS purchases, which have been concentrated in forward purchases of TBAs. As a result, TBA roll prices weakened during the quarter, which in turn provided support to specified pool pay-ups. Pay-ups are price premiums for specified pools relative to their TBA counterparts. Many investors do not wish to take



the greater prepayment risk associated with TBAs, but rather they prefer to buy specified pools with more favorable prepayment characteristics. In contrast, the Federal Reserve, as a purchaser of TBAs, is much less concerned with prepayment risk, and we believe that now that the Federal Reserve has concluded its monthly purchase program of TBAs, specified pool pay-ups will increase. Because prepayments remained low, our Agency interest only securities also performed well, both from a cashflow and price perspective.

Over the course of the third quarter, longer-term interest rates were relatively range-bound. Volatility, while somewhat higher in the third quarter relative to the first and second, was still subdued. Despite intra-quarter upward and downward movements spanning approximately 0.4%, the ten-year U.S. Treasury yield ended the quarter at 2.49%, little changed from where it began. However, shorter-term and intermediate-term interest rates increased during the quarter, as market participants anticipated an eventual tightening of monetary policy by the Federal Reserve. We think it is unlikely that overall interest rate volatility will remain as subdued as it was in the first nine months of the year, and in the early part of the fourth quarter we have already seen an uptick in volatility. This reinforces the importance of our ability to hedge our risks using a variety of tools, including TBAs. Consistent with our strategy, over the course of the third quarter, we continued to hedge against the risk of rising interest rates primarily using interest rate swaps and TBAs. We also believe that volatility can create opportunities for us, particularly given our active style of portfolio management.

Our interest rate hedges generated net losses during the quarter, thereby partially reducing the impact of the net positive return from our assets. Our interest rate swaps are more weighted toward longer-dated maturities and, as previously mentioned, upward interest rate movements during the quarter were concentrated in the shorter and intermediate segments of the yield curve.

One metric that we use to measure our overall prepayment risk is our net Agency premium as a percentage of our long Agency RMBS holdings. Net Agency premium represents the total premium (excess of market value over outstanding principal balance) on long Agency RMBS holdings less the total premium on related net short TBA positions. The lower our net Agency premium, the less we believe we are exposed to market-wide increases in Agency RMBS prepayments. As of both September 30, 2014 and June 30, 2014, our net Agency premium as a percentage of fair value on long Agency RMBS holdings was approximately 3.2%. Excluding TBA positions used to hedge our long Agency RMBS portfolio, our Agency premium as a percentage of fair value was approximately 5.6% and 6.0% as of September 30, 2014 and June 30, 2014, respectively.

We expect to continue to target pools that, taking into account their particular composition and based on our prepayment projections: (1) should generate attractive yields relative to other Agency RMBS and U.S. Treasury securities, (2) should have less prepayment sensitivity to government policy shocks, and/or (3) create opportunities for trading gains once the market recognizes their value, which for newer pools may come only after several months, when actual prepayment experience can be observed. We believe that our research team, our proprietary prepayment models, and our extensive databases remain essential tools in our implementation of this strategy.

#### Non-Agency

As of September 30, 2014, the value of our long non-Agency portfolio was \$33.7 million, as compared to \$35.7 million as of June 30, 2014, representing a decrease of 5.4%.

Despite an increase in volatility in the broader financial markets during the third quarter, non-Agency RMBS exhibited relative resilience. By comparison, high yield credit widened significantly during the quarter. Data underlying non-Agency RMBS remained generally supportive of valuations, although the rate of national home price appreciation continued to decelerate as compared to the pace of 2013. Foreclosure activity ticked up slightly in the third quarter from the prior quarter, but continued to decline on a year-over-year basis. We continue to see attractive value in select non-Agency RMBS sectors. As market yields for non-Agency RMBS have compressed, prudent and careful security selection, based on loan-level analysis performed on a security-by-security basis, remains of paramount importance.

While we believe that fundamental factors, such as continued home price appreciation and declining foreclosure inventory, remain supportive for non-Agency RMBS, we also believe that on the technical side the non-Agency RMBS market remains vulnerable, especially to a significant unexpected increase in long-term interest rates. In the meantime, however, demand for non-Agency RMBS assets remains strong.

#### Financing

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During the first nine months of 2014, we have continued to find repo financing to be readily available for Agency RMBS. In fact, dealers have actually increased their appetite for providing repo financing for Agency specified pools. As a result of this increased competition, our weighted average borrowing rate as of September 30, 2014 declined to 0.33% from 0.38% as of December 31, 2013. To date, our borrowings have consisted solely of repos collateralized by Agency RMBS. Our average

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haircuts on our repo borrowings have also modestly declined as compared to December 31, 2013. We have found increased repo lending appetite from both larger and smaller dealers with more competitive terms. As of September 30, 2014, our outstanding repos were with 10 different counterparties.

#### Critical Accounting Policies

Our consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America, or "U.S. GAAP," Entities in which we have a controlling financial interest, through ownership of the majority of the entities' voting equity interests, or through other contractual right that give us control, are consolidated by us. All inter-company balances and transactions have been eliminated.

Certain of our critical accounting policies require management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. We believe that all of the decisions and assessments upon which our consolidated financial statements are based were reasonable at the time made based upon information available to us at that time. We rely on our Manager and Ellington's experience and analysis of historical and current market data in order to arrive at what we believe to be reasonable estimates. See Note 2 to the consolidated financial statements included in this Quarterly Report on Form 10-Q for a complete discussion of our significant accounting policies. We have identified our most critical accounting policies to be the following:

**Valuation:** We apply Accounting Standards Codification ("ASC") ASC 820-10, Fair Value Measurement and Disclosures ("ASC 820-10"), to our holdings of financial instruments. ASC 820-10 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. Financial instruments include securities and financial derivatives. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in these securities.

The following is a description of the valuation methodologies used for our financial instruments:

Level 1 valuation methodologies include the observation of quoted prices (unadjusted) for identical assets or liabilities in active markets, often received from widely recognized data providers.

Level 2 valuation methodologies include the observation of (i) quoted prices for similar assets or liabilities in active markets, (ii) inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves) in active markets and (iii) quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3 valuation methodologies include (i) the solicitation of valuations from third parties (typically, broker-dealers), (ii) the use of proprietary models that require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions, and (iii) the assessment of observable or reported recent trading activity. We utilize such information to assign a good faith fair value (the estimated price that would be received to sell an asset or paid to transfer a liability in an orderly transaction at the valuation date) to each such financial instrument.

We seek to obtain at least one third-party indicative valuation for each instrument, and often obtain multiple indicative valuations when available. Third-party valuation providers often utilize proprietary models that are highly subjective and also require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions. We have been able to obtain third-party valuations on the vast majority of our assets, and we expect to continue to solicit third-party valuations on substantially all of our assets in the future to the extent practical. Generally, we value each financial instrument at the average of all third-party valuations received and not rejected as described below. Third-party valuations are not binding on us, and while we generally do not adjust such valuations, we may challenge or reject a valuation when, based on our validation criteria, we determine that such valuation is unreasonable or erroneous. Furthermore, we may determine, based on our validation criteria, that for a given instrument the average of the third-party valuations received does not result in what we believe to be fair value, and in such circumstances we may override this average with our own good faith valuation. Our validation criteria include the use of our own models, recent trading activity in the same or similar instruments, and valuations received from third parties. Our valuation process, including the

application of our validation criteria, is overseen by a valuation committee. Because of the inherent uncertainty of valuation, these estimated values may differ significantly from the values that would have been used had a ready market for the financial instruments existed, and the differences could be material to the consolidated financial statements.

See the notes to our consolidated financial statements for more information on valuation.

**Accounting for Mortgage-Backed Securities:** Investments in mortgage-backed securities are recorded on trade date. We have chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for our mortgage-backed securities portfolio. Electing the fair value option allows us to record changes in fair value in our Consolidated Statement of Operations, which, in our view, more appropriately reflects the results of our operations for a particular reporting period as all securities activities will be recorded in a similar manner. As such, the mortgage-backed securities are recorded at fair market value on our Consolidated Balance Sheet and the period change in fair value is recorded in current period earnings on our Consolidated Statement of Operations as a component of Change in net unrealized gains (losses) on mortgage-backed securities.

Realized gains or losses on sales of mortgage-backed securities are included in Net realized gains (losses) on mortgage-backed securities on the Consolidated Statement of Operations, and are recorded at the time of disposition. The cost of positions sold is calculated based on identified cost. Principal write-offs are generally treated as realized losses.

**Interest Income:** We accrete market discounts and amortize market premiums on debt securities using the effective yield method. Accretion of market discount and amortization of market premiums requires the use of a significant amount of judgment and the application of several assumptions including, but not limited to, prepayment assumptions and default rate assumptions, which are re-evaluated not less than quarterly and require the use of a significant amount of judgment. Our accretion of discounts and amortization of premiums for U.S. federal and other tax purposes is likely to differ from the financial accounting treatment of these items.

**Income Taxes:** Prior to May 1, 2013, we, as a business trust with more than one owner, were considered a partnership for U.S. federal income tax purposes. In general, partnerships are not subject to entity-level tax on their income, but the income of a partnership is taxable to its owners on a flow-through basis. Interest, dividend, and other income that we realize from non-U.S. sources and capital gains that we realize on the sale of securities of non-U.S. issuers may be subject to entity-level taxes, such as withholding and other taxes levied by the jurisdiction in which the income is sourced. We made an election to be taxed as a corporation effective as of May 1, 2013, and beginning with our short taxable year May 1, 2013 through December 31, 2013, we elected to be taxed as a REIT for U.S. federal income tax purposes. We follow the authoritative guidance on accounting for and disclosure of uncertainty on tax positions, which requires management to determine whether our tax position is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals of the litigation process, based on the technical merits of the position. For uncertain tax positions, the tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. In the normal course of business, we may be subject to examination by federal, state, local, and foreign jurisdictions, where applicable, for the current period, 2013 or 2012 (our open tax years). We may take positions with respect to certain tax issues which depend on legal interpretation of facts or applicable tax regulations. Should the relevant tax regulators successfully challenge any such positions; we might be found to have a tax liability that has not been recorded in the accompanying consolidated financial statements. Also, management's conclusions regarding the authoritative guidance may be subject to review and adjustment at a later date based on changing tax laws, regulations, and interpretations thereof. There were no amounts accrued for penalties or interest as of or during the periods presented in the consolidated financial statements included in this Quarterly Report on Form 10-Q.

**"Emerging Growth Company" Status:** On April 5, 2012, the Jumpstart Our Business Startups Act, or the "JOBS Act," was signed into law. The JOBS Act contains provisions that, among other things, reduce certain reporting requirements for qualifying public companies. Because we qualify as an "emerging growth company," we may, under Section 7(a)(2)(B) of the Securities Act of 1933, or "the Securities Act," delay adoption of new or revised accounting standards applicable to public companies until such standards would otherwise apply to private companies. We may take advantage of this extended transition period until the first to occur of the date that we (i) are no longer an "emerging growth company" or (ii) affirmatively and irrevocably opt out of this extended transition period. We have elected to take advantage of the benefits of this extended transition period. As a result, our financial statements may not be comparable to those of other public companies that comply with such new or revised accounting standards. Until the date that we are no longer an "emerging growth company" or affirmatively and irrevocably opt out of the exemption provided by Securities Act Section 7(a)(2)(B), upon issuance of a new or revised accounting standard that applies to our financial statements and that has a different effective date for public and private companies, we will

disclose the date on which adoption is required for non-emerging growth companies and the date on which we will adopt the recently issued accounting standard.

Recent Accounting Pronouncements

Refer to the notes to our consolidated financial statements for a description of relevant recent accounting pronouncements.

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Financial Condition  
Investment portfolio

The following tables summarize our mortgage-backed securities portfolio of as of September 30, 2014 and December 31, 2013:

September 30, 2014:

	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gross Unrealized		Fair Value	Weighted Average		
				Gains	Losses		Coupon	Yield	Weighted Average Life(Years) <sup>(1)</sup>
Agency RMBS:									
15-year fixed rate mortgages	\$136,558	\$6,498	\$143,056	\$524	\$(223 )	\$143,357	3.40%	2.51%	5.55
20-year fixed rate mortgages	9,974	596	10,570	93	(1 )	10,662	4.00%	3.44%	7.11
30-year fixed rate mortgages	1,036,799	55,491	1,092,290	11,061	(4,590 )	1,098,761	4.04%	3.29%	8.98
ARMs	43,288	2,945	46,233	121	(233 )	46,121	4.63%	3.16%	6.03
Reverse mortgages	19,523	1,580	21,103	118	(4 )	21,217	4.73%	2.77%	4.86
Interest only securities	n/a	n/a	12,108	2,457	(323 )	14,242	4.19%	10.58%	3.55
Total Agency RMBS	1,246,142	67,110	1,325,360	14,374	(5,374 )	1,334,360	4.02%	3.26%	7.99
Non-Agency RMBS	52,785	(21,568 )	31,217	3,166	(651 )	33,732	2.30%	9.71%	5.22
Total RMBS	\$1,298,927	\$45,542	\$1,356,577	\$17,540	\$(6,025 )	\$1,368,092	3.96%	3.41%	7.91

December 31, 2013:

	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gross Unrealized		Fair Value	Weighted Average		
				Gains	Losses		Coupon	Yield	Weighted Average Life(Years) <sup>(1)</sup>
Agency RMBS:									
15-year fixed rate mortgages	\$179,906	\$7,153	\$187,059	\$65	\$(3,252 )	\$183,872	3.09%	2.52%	5.76
30-year fixed rate mortgages	1,029,629	41,565	1,071,194	490	(28,111 )	1,043,573	3.79%	3.30%	9.80
Adjustable rate mortgages	43,525	2,647	46,172	46	(103 )	46,115	4.72%	3.24%	3.79
Reverse mortgages	7,581	673	8,254	16	(2 )	8,268	4.85%	2.90%	3.41

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Interest only securities	n/a	n/a	10,718	2,841	(32 )	13,527	3.97%	11.79%	5.02
Total Agency RMBS	1,260,641	52,038	1,323,397	3,458	(31,500 )	1,295,355	3.75%	3.26%	8.67
Non-Agency RMBS	50,006	(21,327 )	28,679	2,196	(194 )	30,681	2.84%	9.12%	5.54
Total RMBS	\$1,310,647	\$30,711	\$1,352,076	\$5,654	\$(31,694)	\$1,326,036	3.72%	3.38%	8.56

Average lives of MBS are generally shorter than stated contractual maturities. Average lives are affected by the (1) contractual lives of the underlying mortgages, scheduled periodic payments of principal, and unscheduled prepayments of principal.

The vast majority of our capital is allocated to our Agency RMBS strategy, which we began implementing in April 2013 and which includes investments in Agency pools and Agency CMOs. Within this strategy, we generally target Agency RMBS pools that, taking into account their particular composition and based on our prepayment projections: (1) will generate attractive yields relative to other Agency RMBS and U.S. Treasury securities, (2) will have less prepayment sensitivity to government policy shocks and/or (3) create opportunities for trading gains once the market recognizes their value, which for newer pools may come only after several months when actual prepayment experience can be observed. As of both September 30, 2014 and December 31, 2013, investments in non-Agency RMBS constituted a relatively small portion of our total investments.



Our most prevalent method of financing RMBS is through short-term repurchase agreements, which generally have maturities of 180 days or less. The weighted average life of the RMBS we own is generally much longer. Consequently, the weighted average term of our repurchase agreement financings will almost always be substantially shorter than the expected average maturity of our RMBS. This mismatch in maturities, together with the uncertainty of RMBS prepayments, and other potential changes in timing and/or amount of cash flows on our RMBS assets, creates the risk that changes in interest rates will cause our financing costs with respect to our RMBS to increase relative to the income on our RMBS over the term of our investments.

#### Financial Derivatives

The following table summarizes our portfolio of financial derivative holdings as of September 30, 2014 and December 31, 2013:

(In thousands)	September 30, 2014	December 31, 2013	
Financial derivatives—assets, at fair value:			
TBA securities purchase contracts	\$28	\$1	
TBA securities sale contracts	369	2,262	
Fixed payer interest rate swaps	8,042	32,700	
Total financial derivatives—assets, at fair value:	\$8,439	\$34,963	
Financial derivatives—liabilities, at fair value:			
TBA securities purchase contracts	(81	) —	
TBA securities sale contracts	(411	) (28	)
Fixed payer interest rate swaps	(2,333	) (956	)
Swaptions	(25	) (85	)
Total financial derivatives—liabilities, at fair value:	\$(2,850	) \$(1,069	)
Total	\$5,589	\$33,894	

Pursuant to our hedging program, we engage in a variety of interest rate hedging activities that are designed to reduce the interest rate risk with respect to the liabilities incurred to acquire or hold RMBS. These interest rate hedges generally seek to reduce the interest rate sensitivity of our liabilities or, in other words, reduce the volatility of our financing cost over time attributable to interest rate changes. Our interest rate hedging transactions may include:

- Interest rate swaps (a contract exchanging a variable rate for a fixed rate, or vice versa);
- Interest rate swaptions (options to enter into interest rate swaps at a future date);
- TBA forward contracts on Agency pass-through certificates;
- U.S. Treasury securities;
- Eurodollar and U.S. Treasury futures; and
- Other derivatives.

We generally enter into these transactions to offset the potential adverse effects of rising interest rates on short-term repurchase agreements. Our repurchase agreements generally have maturities of up to 180 days and carry interest rates that are determined by reference to LIBOR or correlated benchmark rates for those same periods. As each then-existing fixed rate repo borrowing matures, it will generally be replaced with a new fixed rate repo borrowing based on market interest rates established at that future date.

In the case of interest rate swaps, most of our agreements are structured such that we receive payments based on a variable interest rate and make payments based on a fixed interest rate. The variable interest rate on which payments are received is generally calculated based on various reset mechanisms for LIBOR. To the extent that our future repo borrowing costs continue to be highly correlated with LIBOR, our swap agreements help to reduce the variability of our overall borrowing costs, thus reducing risk to the extent we hold fixed rate assets that are financed with repo borrowings.

In the case of TBAs, most of our positions are short TBA positions with a negative duration, meaning that as interest rates rise, the value of the short position increases, so these positions serve as a hedge against increases in interest rates. In the event that interest rates rise, the increase in value of the short TBA position serves to offset corollary increases in our current and/or future borrowing costs under our repurchase agreements. While we primarily use TBAs to hedge interest rate risk, from time to time, we also hold net long positions in certain TBA securities as a means of acquiring exposure to Agency RMBS.



As of September 30, 2014, as part of our interest rate hedging program, we also held a short position in a five-year U.S. Treasury security, with a principal amount of \$2.5 million and a fair value of \$2.5 million.

The composition and relative mix of our hedges may vary from period to period given the amount of our liabilities outstanding or anticipated to be entered into, the overall market environment and our view as to which instruments best enable us to execute our hedging goals.

#### Leverage

The following table summarizes our outstanding liabilities under repurchase agreements as of September 30, 2014 and December 31, 2013. We had no other borrowings outstanding.

Remaining Days to Maturity	September 30, 2014			December 31, 2013		
	Borrowings Outstanding	Interest Rate	Weighted Average Remaining Days to Maturity	Borrowings Outstanding	Interest Rate	Weighted Average Remaining Days to Maturity
	(In thousands)					
30 days or less	\$325,079	0.34	% 16	\$338,700	0.35	% 14
31-60 days	519,999	0.33	45	531,799	0.39	46
61-90 days	338,669	0.33	73	326,386	0.38	72
91-120 days	22,192	0.38	106	109,476	0.45	100
121-150 days	27,394	0.38	135	3,986	0.56	136
Total	\$1,233,333	0.33	% 48	\$1,310,347	0.38	% 49

We finance our assets with what we believe to be a prudent amount of leverage, which will vary from time to time based upon the particular characteristics of our portfolio, availability of financing, and market conditions. As of both September 30, 2014 and December 31, 2013, our borrowings consisted entirely of repurchase agreements collateralized by our Agency RMBS. Because our strategy is flexible, dynamic, and opportunistic, our overall leverage will vary over time. As of September 30, 2014 and December 31, 2013, our total debt-to-equity ratio was 7.27 to 1 and 7.84 to 1, respectively. Collateral transferred with respect to our outstanding repo borrowings as of September 30, 2014 and December 31, 2013 had an aggregate fair value of \$1.3 billion and \$1.4 billion, respectively, and was entirely comprised of Agency RMBS.

#### Shareholders' Equity

As of September 30, 2014, our shareholders' equity increased to \$169.5 million from \$167.2 million as of December 31, 2013. This increase principally consisted of an increase in net income partially offset by dividends declared. As of September 30, 2014, our book value per share was \$18.53 as compared to \$18.29 as of December 31, 2013.

As of December 31, 2013, our shareholders' equity increased to \$167.2 million from \$31.0 million as of December 31, 2012. On May 1, 2013, we priced an initial public offering of our common shares, pursuant to which we sold 6,450,000 shares to the public at a price of \$20.00 per share. Concurrent with the initial public offering, we completed a private placement with our initial shareholders which resulted in gross proceeds to us of \$21.0 million and the issuance of 1,050,000 shares at a price of \$20.00 per share. Total gross proceeds from the initial public offering and concurrent private placement were \$150.0 million. Proceeds, net of offering costs, were approximately \$148.5 million. In addition, for the year ended December 31, 2013, we recorded a net loss of \$1.9 million. Our net loss was primarily the result of net realized and unrealized losses on our mortgage-backed securities, partially offset by net realized and unrealized gain on our financial derivatives and net interest income. Our Board of Trustees declared three dividends during the year ended December 31, 2013 totaling \$1.14 per share. For the year ended December 31, 2013, total cash dividends paid or payable amounted to \$10.4 million and we also incurred \$0.05 million of stock based compensation costs. As of December 31, 2013, our book value per share was \$18.29 as compared to \$18.96 as of December 31, 2012.

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Results of Operations for the Three Month Periods Ended September 30, 2014 and 2013:

The following table summarizes our results of operations for the three month periods ended September 30, 2014 and 2013:

(In thousands except for per share amounts)	Three Month Period Ended September 30, 2014	Three Month Period Ended September 30, 2013
Net Interest income		
Net interest income	\$10,363	\$9,975
Expenses		
Management fees	574	644
Other operating expenses	720	713
Total expenses	1,294	1,357
Other Income (Loss)		
Net realized and change in net unrealized gains (losses) on mortgage-backed securities	(3,425	) 6,066
Net realized and change in net unrealized gains (losses) on financial derivatives	(2,111	) (7,899 )
Total Other Income (Loss)	(5,536	) (1,833 )
Net Income (Loss)	\$3,533	\$6,785
Net Income (Loss) Per Common Share	\$0.39	\$0.74

Core Earnings

Core Earnings consists of net income (loss), excluding realized and unrealized gains and losses on mortgage-backed securities and financial derivatives, and, if applicable, items of income or loss that are of a non-recurring nature. Core Earnings includes net realized and unrealized gains and losses associated with payments and accruals of periodic payments on interest rate swaps. Core Earnings is a supplemental non-GAAP financial measure that we present as an additional measure of our operating performance. We believe Core Earnings provides information useful to investors because it is a metric utilized by management to assess our performance and to evaluate the effective net yield provided by our portfolio. Moreover, one of our objectives is to generate income from the net interest margin on our portfolio, and we use Core Earnings to help measure the extent to which we are achieving this objective. However, because Core Earnings is an incomplete measure of our financial results and differs from net income (loss) computed in accordance with GAAP, it should be considered as supplementary to, and not as a substitute for, our net income (loss) computed in accordance with GAAP.

The table below reconciles Core Earnings for the three month periods ended September 30, 2014 and 2013 to the line, Net Income (Loss), on our Consolidated Statement of Operations, which we believe is the most directly comparable GAAP measure:

(In thousands except share amounts)	Three Month Period Ended September 30, 2014	Three Month Period Ended September 30, 2013
Net Income (Loss)	\$3,533	\$6,785
Less:		
Net realized gains (losses) on mortgage-backed securities	2,030	(24,173 )
Net realized gains (losses) on financial derivatives, excluding periodic payments <sup>(1)</sup>	(3,713	) 4,224
Change in net unrealized gains (losses) on mortgage-backed securities	(5,455	) 30,239
Change in net unrealized gains (losses) on financial derivatives, excluding accrued periodic payments <sup>(2)</sup>	3,755	(9,063 )
Subtotal	(3,383	) 1,227
Core Earnings	\$6,916	\$5,558

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Weighted Average Shares Outstanding	9,141,892	9,133,940
Core Earnings Per Share	\$0.76	\$0.61

For the three month period ended September 30, 2014, represents Net realized gains (losses) on financial derivatives of \$(4,391) less Net realized gains (losses) on periodic settlements of interest rate swaps of \$(678). For (1) the three month period ended September 30, 2013, represents Net realized gains (losses) on financial derivatives of \$4,273 less Net realized gains (losses) on periodic settlements of interest rate swaps of \$49. See Note 5 in the notes to the consolidated financial statements.

For the three month period ended September 30, 2014, represents Net change in unrealized gains (losses) on financial derivatives of \$2,280 less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate swaps of \$(1,475). For the three month period ended September 30, 2013, represents Net change in (2) unrealized gains (losses) on financial derivatives of \$(12,172) less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate swaps of \$(3,109). See Note 5 in the notes to the consolidated financial statements.

#### Net Income (Loss)

We had net income for the three month period ended September 30, 2014 of \$3.5 million, or \$0.39 per share, and we had Core Earnings of \$6.9 million, or \$0.76 per share. For the three month period ended September 30, 2013, we had net income of \$6.8 million, or \$0.74 per share, and we had Core Earnings of \$5.6 million, or \$0.61 per share. The decrease in net income period over period was principally due to a decrease in change in net realized and unrealized gains (losses) on mortgage-backed securities.

#### Interest Income

Our primary source of income is the interest earned on our mortgage-backed securities. Our portfolio as of both September 30, 2014 and 2013 consisted primarily of Agency RMBS, and to a lesser extent, non-Agency RMBS, and we earned approximately \$11.5 million and \$11.2 million in interest income on these securities for the three month periods ended September 30, 2014 and 2013, respectively. The slight period-over-period increase in interest income was due to a higher weighted average yield of the RMBS portfolio in the current period relative to the prior period. Yields on Agency RMBS have generally been higher in 2014 as compared to 2013. For the three month period ended September 30, 2014, the weighted average yield on our mortgage-backed securities was 3.40% as compared to 3.09% for the three month period ended September 30, 2013.

#### Interest Expense

For the three month periods ended September 30, 2014 and 2013, the vast majority of interest expense that we incurred was related to our repo borrowings, which we use to finance our assets. Our average outstanding borrowings for the three month period ended September 30, 2014 was \$1.25 billion, resulting in an annualized average cost of funds of 0.34%. Our average outstanding borrowings for the three month period ended September 30, 2013 was \$1.30 billion, resulting in an annualized average cost of funds of 0.38%. Our interest expense for the three month period ended September 30, 2014 was \$1.1 million as compared to \$1.2 million for the three month period ended September 30, 2013. This decrease was mainly due to a lower average repo borrowing rate.

The following table shows information related to our annualized average cost of funds for the three month periods ended September 30, 2014 and 2013.

(\$ in thousands)	Average Borrowed Funds	Interest Expense	Annualized Average Cost of Funds	Average One-Month LIBOR	Average Six-Month LIBOR
Three Month Period Ended September 30, 2014	\$1,251,296	\$1,072	0.34 %	0.15 %	0.33 %
Three Month Period Ended September 30, 2013	\$1,296,042	\$1,242	0.38 %	0.19 %	0.39 %

As an alternative measure of our cost of funds, we add to our average interest cost the net periodic amounts paid or payable by us on our interest rate swaps as a percentage of our average outstanding borrowings. Our net periodic expense paid or payable under our interest rate swaps was \$2.2 million for the three month period ended September 30, 2014, or 0.68% of our average outstanding borrowings on an annualized basis, thereby resulting in annualized average cost of funds including interest rate swaps of 1.02%. Our net periodic expense paid or payable under our interest rate swaps was \$3.1 million for the three month period ended September 30, 2013, or 0.94% of our average outstanding borrowings on an annualized basis, thereby resulting in annualized average cost of funds including interest rate swaps of 1.32%. This metric does not take into account other instruments that we use to hedge interest rate risk, such as TBAs, U.S. Treasury securities, and futures.

#### Management Fees

For both three month periods ended September 30, 2014 and 2013, our management fee expense was approximately \$0.6 million, which is based on shareholders' equity at the end of each quarter, excluding any unrealized gains (losses) included in shareholders' equity. Management fees for the three month periods ended September 30, 2014 were essentially flat as compared to the three month period ended September 30, 2013.

Other Operating Expenses

Other operating expenses include professional fees and various other expenses necessary to operate our business.  
Other

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operating expenses for both three month periods ended September 30, 2014 and 2013 were approximately \$0.7 million. Our expense ratio, which represents our annualized management fees and other operating expenses as a percentage of our average shareholders' equity, was 3.0% for the three month period ended September 30, 2014, as compared to 3.2% for the three month period ended September 30, 2013.

Other Income (Loss)

Other income (loss) consisted of net realized and net change in unrealized gain (losses) on mortgage-backed securities and financial derivatives. For the three month period ended September 30, 2014, other loss was \$5.5 million, and consisted of net realized and unrealized losses of \$3.4 million on our mortgage-backed securities, primarily our Agency RMBS, and net realized and unrealized losses of approximately \$2.1 million on our financial derivatives. Prices of specified pools declined somewhat over the period, and our fixed payer interest rate swaps, which were more weighted toward longer dated maturities, did not appreciate since most of the upward interest rate movements during the period were concentrated around shorter-term and intermediate-term interest rates.

Other loss for the three month period ended September 30, 2013 was \$1.8 million and consisted of net realized and unrealized losses on our financial derivatives of \$7.9 million partially offset by realized and unrealized gains of \$6.1 million on our mortgage-backed securities.

Results of Operations for the Nine Month Periods Ended September 30, 2014 and 2013:

The following table summarizes our results of operations for the nine month periods ended September 30, 2014 and 2013:

(In thousands except for per share amounts)	Nine Month Period Ended September 30, 2014	Nine Month Period Ended September 30, 2013
Net Interest income		
Net interest income	\$31,672	\$14,042
Expenses		
Management fees	1,733	1,466
Other operating expenses	2,272	1,448
Total expenses	4,005	2,914
Other Income (Loss)		
Net realized and change in net unrealized gains (losses) on mortgage-backed securities	36,937	(41,681 )
Net realized and change in net unrealized gains (losses) on financial derivatives	(47,260 )	28,764
Total Other Income (Loss)	(10,323 )	(12,917 )
Net Income (Loss)	\$17,344	\$(1,789 )
Net Income (Loss) Per Common Share	\$1.90	\$(0.31 )



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Core Earnings

The table below reconciles Core Earnings for the nine month periods ended September 30, 2014 and 2013 to the line, Net Income (Loss), on our Consolidated Statement of Operations, which we believe is the most directly comparable GAAP measure:

(In thousands except share amounts)	Nine Month Period Ended September 30, 2014	Nine Month Period Ended September 30, 2013	
Net Income (Loss)	\$17,344	\$(1,789	)
Less:			
Net realized gains (losses) on mortgage-backed securities	(613	)	(26,290 )
Net realized gains (losses) on financial derivatives, excluding periodic payments <sup>(1)</sup>	(13,381	)	12,670
Change in net unrealized gains (losses) on mortgage-backed securities	37,550	(15,391	)
Change in net unrealized gains (losses) on financial derivatives, excluding accrued periodic payments <sup>(2)</sup>	(26,990	)	20,265
Subtotal	(3,434	)	(8,746 )
Core Earnings	\$20,778	\$6,957	
Weighted Average Shares Outstanding	9,140,533	5,699,501	
Core Earnings Per Share	\$2.27	\$1.22	

For the nine month period ended September 30, 2014, represents Net realized gains (losses) on financial derivatives of \$(18,955) less Net realized gains (losses) on periodic settlements of interest rate swaps of \$(5,574).

(1) For the nine month period ended September 30, 2013, represents Net realized gains (losses) on financial derivatives of \$12,650 less Net realized gains (losses) on periodic settlements of interest rate swaps of \$(20). See Note 5 in the notes to the consolidated financial statements.

(2) For the nine month period ended September 30, 2014, represents Net change in unrealized gains (losses) on financial derivatives of \$(28,305) less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate swaps of \$(1,315). For the nine month period ended September 30, 2013, represents Net change in unrealized gains (losses) on financial derivatives of \$16,114 less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate swaps of \$(4,151). See Note 5 in the notes to the consolidated financial statements.

Net Income (Loss)

We had net income for the nine month period ended September 30, 2014 of \$17.3 million, or \$1.90 per share, and we had Core Earnings of \$20.8 million, or \$2.27 per share. For the nine month period ended September 30, 2013, we had a net loss of \$(1.8) million, or \$(0.31) per share, and we had Core Earnings of \$7.0 million, or \$1.22 per share. The increase in net income period over period was principally due to an increase in interest income as well as a decrease in net realized and unrealized losses on our mortgage-backed securities and financial derivatives.

Interest Income

Our portfolio as of both September 30, 2014 and 2013 consisted primarily of Agency RMBS, and to a lesser extent, non-Agency RMBS. We earned approximately \$35.0 million and \$15.8 million in interest income on these securities for the nine month periods ended September 30, 2014 and 2013, respectively. The period-over-period increase in interest income resulted from a larger portfolio of assets held in the current period, while in 2013, prior to our May initial public offering, our asset base was smaller. For the nine months ended September 30, 2014, the annualized weighted average yield on our mortgage-backed securities was 3.44%. For the nine month period ended September 30, 2014, interest income includes \$0.4 million related to the effects of a downward adjustment to premium amortization (accompanied by a corresponding \$0.4 million downward adjustment to realized and unrealized gains), as higher interest rates have caused a decline in prepayments.

Interest Expense

For the nine month periods ended September 30, 2014 and 2013, the vast majority of interest expense that we incurred was related to our repo borrowings, which we use to finance our assets. Our average outstanding borrowings for the

nine month period ended September 30, 2014 was \$1.25 billion, resulting in an annualized average cost of funds of 0.35%. Our average outstanding borrowings for the nine month period ended September 30, 2013 was \$620.4 million, resulting in an annualized average cost of funds of 0.38%. Our interest expense for the nine month period ended September 30, 2014 was \$3.3 million as compared to \$1.8 million for the nine month period ended September 30, 2013. This increase was mainly due to our increased average outstanding repo borrowings, as we did not have any repurchase agreements prior to April 2013.

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The following table shows information related to our annualized average cost of funds for the nine month periods ended September 30, 2014 and 2013.

(\$ in thousands)	Average Borrowed Funds	Interest Expense	Annualized Average Cost of Funds	Average One-Month LIBOR	Average Six-Month LIBOR
Nine Month Period Ended September 30, 2014	\$1,250,334	\$3,277	0.35 %	0.15 %	0.33 %
Nine Month Period Ended September 30, 2013	\$620,371	\$1,765	0.38 %	0.19 %	0.43 %

As an alternative measure of our cost of funds, we add to our average interest cost the net periodic amounts paid or payable by us on our interest rate swaps as a percentage of our average outstanding borrowings. Our net periodic expense paid or payable under our interest rate swaps was \$6.9 million for the nine month period ended September 30, 2014, or 0.74% of our average outstanding borrowings on an annualized basis, thereby resulting in an annualized average cost of funds including interest rate swaps of 1.09%. Our net periodic expense paid or payable under our interest rate swaps was \$4.2 million for the nine month period ended September 30, 2013, or 0.90% of our average outstanding borrowings on an annualized basis, thereby resulting in an annualized average cost of funds including interest rate swaps of 1.28%. This metric does not take into account other instruments that we use to hedge interest rate risk, such as TBAs, U.S. Treasury securities, and futures.

#### Management Fees

For the nine month periods ended September 30, 2014 and 2013, our management fee expense was approximately \$1.7 million and \$1.5 million, respectively, which is based on shareholders' equity at the end of each quarter, excluding any unrealized gains (losses) included in shareholders' equity. The increase in management fees for the nine month period ended September 30, 2014 was primarily due to our larger capital base.

#### Other Operating Expenses

Other operating expenses include professional fees and various other expenses necessary to operate our business. Other operating expenses for the nine month period ended September 30, 2014 were approximately \$2.3 million, while for the nine month period ended September 30, 2013, our other operating expenses were approximately \$1.4 million. The increase in operating expenses period over period is due to the commensurate ramp-up in our operations following our May 2013 initial public offering. Our expense ratio, which represents our management fees and other operating expenses as a percentage of our average shareholders' equity was 3.2% on an annualized basis for the nine month period ended September 30, 2014, as compared to 3.8% for the nine month period ended September 30, 2013.

#### Other Income (Loss)

Other income (loss) consisted of net realized and net change in unrealized gain (losses) on mortgage-backed securities and financial derivatives. For the nine month period ended September 30, 2014, other loss was \$10.3 million, and consisted of net realized and unrealized losses of \$47.3 million on our financial derivatives, partially offset by net realized and unrealized gains of approximately \$36.9 million on our mortgage-backed securities, primarily our Agency RMBS. Long-term interest rates generally declined over the course of the nine month period, causing our mortgage-backed securities to increase in value and our derivatives to decline in value. Other loss for the nine month period ended September 30, 2013 was \$12.9 million and consisted of net realized and unrealized losses of \$41.7 million on our RMBS, principally our Agency RMBS, partially offset by net realized and unrealized gains of approximately \$28.8 million on our financial derivatives.

#### Liquidity and Capital Resources

Liquidity refers to our ability to meet our cash needs, including repaying our borrowings, funding and maintaining RMBS and other assets, paying dividends, and other general business needs. Our short-term (one year or less) and long-term liquidity requirements include acquisition costs for assets we acquire, payment of our management fee, compliance with margin requirements under our repurchase agreements, TBA and other financial derivative contracts, repayment of repurchase agreement borrowings to the extent we are unable or unwilling to extend our repurchase agreements, the payment of dividends, and payment of our general operating expenses. Our capital resources primarily include cash on hand, cash flow from our investments (including monthly principal and interest payments received on our RMBS and proceeds from the sale of mortgage-backed securities), borrowings under repurchase agreements, and proceeds from equity offerings. We expect that these sources of funds will be sufficient to meet our short-term and

long-term liquidity needs.

We borrow funds in the form of repurchase agreements. The terms of these borrowings under our Master Repurchase Agreements, or "MRAs," generally conform to the terms in the standard master repurchase agreement as published by the

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Securities Industry and Financial Markets Association as to repayment and margin requirements. In addition, each lender typically requires that we include supplemental terms and conditions to the standard MRA. Typical supplemental terms and conditions include the addition of or changes to provisions relating to margin calls, net asset value requirements, cross default provisions, certain key person events, changes in corporate structure, and requirements that all controversies related to the repurchase agreement be litigated in a particular jurisdiction. These provisions may differ for each of our lenders.

As of September 30, 2014 and December 31, 2013, we had \$1.2 billion and \$1.3 billion outstanding under our repurchase agreements, respectively. As of September 30, 2014, we had MRAs in place with thirteen counterparties and our outstanding repurchase agreements were with ten counterparties.

Amount at risk represents the aggregate excess, if any, for each counterparty of the fair value of collateral held by such counterparty over the amounts outstanding under repurchase agreements. The following table reflects counterparties for which the amounts at risk relating to the Company's repurchase agreements was greater than 5% of shareholders' equity as of September 30, 2014 and December 31, 2013.

September 30, 2014:

Counterparty	Amount at Risk <sup>(1)</sup>	Weighted Average Remaining Days to Maturity	Percentage of Shareholders' Equity	
	(In thousands)			
Deutsche Bank Securities	\$11,411	56	6.7	%
J.P. Morgan Securities Inc.	\$10,610	56	6.3	%
Barclays Capital Inc.	\$10,355	34	6.1	%
Bank of America Securities	\$10,332	54	6.1	%
RBC Capital Markets LLC	\$10,270	48	6.1	%

(1) Amounts at risk exclude, in aggregate, \$3.5 million of net accrued interest, defined as accrued interest on securities held as collateral less interest payable on cash borrowed.

December 31, 2013:

Counterparty	Amount at Risk <sup>(1)</sup>	Weighted Average Remaining Days to Maturity	Percentage of Shareholders' Equity	
	(In thousands)			
Deutsche Bank Securities	\$20,180	29	12.1	%
J.P. Morgan Securities Inc.	\$13,919	54	8.3	%
Bank of America Securities	\$11,588	69	6.9	%

(1) Amounts at risk exclude, in aggregate, \$2.3 million of net accrued interest, defined as accrued interest on securities held as collateral less interest payable on cash borrowed.

The amounts borrowed under our repurchase agreements are generally subject to the application of "haircuts." A haircut is the percentage discount that a repo lender applies to the market value of an asset serving as collateral for a repo borrowing, for the purpose of determining whether such reverse repo borrowing is adequately collateralized. As of September 30, 2014 and December 31, 2013, the weighted average contractual haircut applicable to the assets that serve as collateral for the Company's outstanding repo borrowings was 4.3% and 4.6%, respectively. As of both September 30, 2014 and December 31, 2013, all of the Company's repo borrowings were related to its Agency RMBS. We held cash and cash equivalents of approximately \$51.1 million and \$50.1 million as of September 30, 2014 and December 31, 2013, respectively.

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We may declare dividends based on, among other things, our earnings, our financial condition, the REIT qualification requirements of the Internal Revenue Code, our working capital needs and new opportunities. The declaration of dividends to our shareholders and the amount of such dividends are at the discretion of our Board of Trustees. The following table sets forth the dividend distributions authorized by the Board of Trustees for the periods indicated below:

### Nine Month Period Ended September 30, 2014

	Dividend Per Share	Dividend Amount (In thousands)	Declaration Date	Record Date	Payment Date
First Quarter	\$0.55	\$5,027	March 12, 2014	March 31, 2014	April 28, 2014
Second Quarter	\$0.55	\$5,027	June 17, 2014	June 30, 2014	July 25, 2014
Third Quarter	\$0.55	\$5,032	September 11, 2014	September 30, 2014	October 27, 2014

### Nine Month Period Ended September 30, 2013

	Dividend Per Share	Dividend Amount (In thousands)	Declaration Date	Record Date	Payment Date
Second Quarter	\$0.14	\$1,279	June 18, 2013	June 28, 2013	July 26, 2013
Third Quarter	\$0.50	\$4,569	September 17, 2013	September 27, 2013	October 25, 2013

The Board of Trustees did not declare any cash dividends prior to the second quarter of 2013.

For the nine month period ended September 30, 2014, our operating activities provided net cash of \$11.0 million and our investing activities provided net cash of \$81.8 million. Our repo activity used to finance our Agency RMBS (including repayments, in conjunction with the sales of Agency RMBS, of amounts borrowed under our repurchase agreements) used net cash of \$77.0 million. Thus our operating and investing activities, when combined with our net repo financing activities, provided net cash of \$15.8 million. We used \$14.6 million to pay dividends and \$0.2 million to pay offering costs. As a result of these activities, there was an increase in our cash holdings of \$1.0 million from \$50.1 million as of December 31, 2013 to \$51.1 million as of September 30, 2014.

For the nine month period ended September 30, 2013, our operating activities provided net cash of \$18.6 million and our investing activities used net cash of \$1.43 billion. Our repo activity used to finance our Agency RMBS (including repayments, in conjunction with the sales of Agency RMBS, of amounts borrowed under our repurchase agreements) provided net cash of \$1.29 billion. Thus our operating and investing activities, when combined with our net repo financing activities, used net cash of \$121.1 million for the nine month period ended September 30, 2013. We received \$150.0 million in gross proceeds from issuance of common shares. We used \$1.3 million to pay dividends and \$1.5 million to pay offering costs. As a result of these activities, there was an increase in our cash holdings of \$26.2 million from \$18.2 million as of December 31, 2012 to \$44.3 million as of September 30, 2013.

On August 13, 2013, our Board of Trustees approved the adoption of a \$10 million share repurchase program. The program, which is open-ended in duration, allows us to make repurchases from time to time on the open market or in negotiated transactions. Repurchases are at our discretion, subject to applicable law, share availability, price and our financial performance, among other considerations. No purchases have been made under the program to date. Based on our current portfolio, amount of free cash on hand, debt-to-equity ratio and current and anticipated availability of credit, we believe that our capital resources will be sufficient to enable us to meet anticipated short-term and long-term liquidity requirements.

We are not required by our investment guidelines to maintain any specific debt-to-equity ratio, and we believe that the appropriate leverage for the particular assets we hold depends on the credit quality and risk of those assets, as well as the general availability and terms of stable and reliable financing for those assets.

### Contractual Obligations and Commitments

We are a party to a management agreement with our Manager. Pursuant to that agreement, our Manager is entitled to receive a management fee based on shareholders' equity, reimbursement of certain expenses and, in certain circumstances, a termination fee. Such fees and expenses do not have fixed and determinable payments. For a description of the management agreement provisions, see Note 10 to our consolidated financial statements.



We enter into repurchase agreements with third-party broker-dealers whereby we sell securities to such broker-dealers at agreed-upon purchase prices at the initiation of the repurchase agreements and agree to repurchase such securities at predetermined repurchase prices and termination dates, thus providing the broker-dealers with an implied interest rate on the funds initially transferred to us by the broker-dealers. We may enter into reverse repurchase agreements with third-party broker-dealers whereby we purchase securities under agreements to resell at an agreed-upon price and date. In general, we most often will enter into reverse repurchase agreement transactions in order to effectively borrow securities that we can then deliver to counterparties to whom we have made short sales of the same securities. The implied interest rates on the repurchase agreements and reverse repurchase agreements we enter into are based upon competitive market rates at the time of initiation. Repurchase agreements and reverse repurchase agreements that are conducted with the same counterparty may be reported on a net basis if they meet the requirements of ASC 210-20, Balance Sheet, Offsetting. As of both September 30, 2014 and December 31, 2013, there were no repurchase agreements and reverse repurchase agreements reported on a net basis on the Consolidated Balance Sheet.

As of September 30, 2014 we had \$1.2 billion of outstanding borrowings with ten counterparties and as of December 31, 2013 we had \$1.3 billion of outstanding borrowings with nine counterparties. As of September 30, 2014, we had MRAs with thirteen counterparties. We expect to continue to have discussions with various other financial institutions in order to expand our repurchase agreement capacity.

#### Off-Balance Sheet Arrangements

As of September 30, 2014 and December 31, 2013, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide funding to any such entities. As such, we are not materially exposed to any market, credit, liquidity, or financing risk that could arise if we had engaged in such relationships.

#### Inflation

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

The primary components of our market risk are related to interest rate risk, prepayment risk, and credit risk. We seek to actively manage these and other risks and to acquire and hold assets that we believe justify bearing those risks, and to maintain capital levels consistent with those risks.

#### Interest Rate Risk

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations, and other factors beyond our control. We are subject to interest rate risk in connection with most of our assets and liabilities. For some securities in our portfolio, the coupon interest rates on, and therefore also the values of, such securities are highly sensitive to interest rate movements, such as inverse floating rate RMBS, which benefit from falling interest rates. Subject to qualifying and maintaining our qualification as a REIT and our exemption from registration under the Investment Company Act, we opportunistically hedge our interest rate risk by entering into interest rate swaps, TBAs, U.S. Treasury securities, Eurodollar and U.S. Treasury futures, and other instruments. In general, such hedging instruments are used to offset the large majority of the interest rate risk we estimate to arise from our repurchase agreement indebtedness associated with our Agency RMBS positions. Hedging instruments may also be used to offset a portion of the interest rate risk arising from our repurchase agreement liabilities associated with non-Agency RMBS positions, if any.



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In addition to measuring and mitigating the risk related to changes in interest rates with respect to the generally shorter-term liabilities we incur to acquire and hold generally longer-lived RMBS, we also monitor the effect of changes in interest rates on the discounted present value of our portfolio of assets and liabilities. The following sensitivity analysis table shows the estimated impact on the fair value of our portfolio segregated by certain identified categories as of September 30, 2014, assuming a static portfolio and immediate and parallel shifts in interest rates from current levels as indicated below.

(In thousands)	Estimated Change in Value for a Decrease in Interest Rates by		Estimated Change in Value for an Increase in Interest Rates by	
	50 Basis Points	100 Basis Points	50 Basis Points	100 Basis Points
Agency RMBS, excluding TBAs	\$25,425	\$42,885	\$(33,391)	\$(74,747)
TBAs	(8,328)	(13,703)	11,284	25,523
Non-Agency RMBS	487	991	(470)	(924)
U.S. Treasury Securities, and Interest Rate Swaps and Swaptions	(19,748)	(40,490)	18,753	36,511
Repurchase and Reverse Repurchase Agreements	(540)	(540)	803	1,606
Total	\$(2,704)	\$(10,857)	\$(3,021)	\$(12,031)

Our analysis of interest rate risk is derived from Ellington's proprietary models as well as third-party information and analytics. Many assumptions have been made in connection with the calculations set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. For example, for each hypothetical immediate shift in interest rates, assumptions have been made as to the response of mortgage prepayment rates, the shape of the yield curve, and market volatilities of interest rates; each of the foregoing factors can significantly and adversely affect the fair value of our interest rate sensitive instruments. The above analysis utilizes assumptions and estimates based on management's judgment and experience, and relies on financial models, which are inherently imperfect; in fact, different models can produce different results for the same securities. While the table above reflects the estimated impacts of immediate parallel interest rate increases and decreases on specific categories of instruments in our portfolio, we intend to actively trade many of the instruments in our portfolio and intend to diversify our portfolio to reflect a portfolio comprised primarily of Agency RMBS, and, to a lesser extent, non-Agency RMBS and mortgage-related assets. Therefore, our current or future portfolios may have risks that differ significantly from those of our September 30, 2014 portfolio estimated above. Moreover, the impact of changing interest rates on fair value can change significantly when interest rates change by a greater amount than the hypothetical shifts assumed above. Furthermore, our portfolio is subject to many risks other than interest rate risks, and these additional risks may or may not be correlated with changes in interest rates. For all of the foregoing reasons and others, the table above is for illustrative purposes only and actual changes in interest rates would likely cause changes in the actual fair value of our portfolio that would differ from those presented above, and such differences might be significant and adverse. See "Special Note Regarding Forward-Looking Statements."

#### Prepayment Risk

Prepayment risk is the risk of change, whether an increase or a decrease, in the rate at which principal is returned in respect of mortgage loans underlying RMBS, including both through voluntary prepayments and through liquidations due to defaults and foreclosures. This rate of prepayment is affected by a variety of factors, including the prevailing level of interest rates as well as economic, demographic, tax, social, legal, and other factors. Changes in prepayment rates will have varying effects on the different types of securities in our portfolio. We attempt to take these effects into account in making asset management decisions with respect to our assets. Additionally, increases in prepayment rates may cause us to experience losses on our interest only securities, or "IOs," and inverse interest only securities, or "IIOs," as these securities are extremely sensitive to prepayment rates. Finally, prepayment rates, besides being subject to interest rates and borrower behavior, are also substantially affected by government policy and regulation.

#### Credit Risk

We are subject to credit risk in connection with our assets, especially our non-Agency RMBS. Credit losses on real estate loans underlying our non-Agency RMBS can occur for many reasons, including, but not limited to, poor

origination practices, fraud, faulty appraisals, documentation errors, poor underwriting, legal errors, poor servicing practices, weak economic conditions, decline in the value of homes, special hazards, earthquakes and other natural events, over-leveraging of the borrower on the property, reduction in market rents and occupancies and poor property management services in the case of rented homes, changes in legal protections for lenders, reduction in personal income, job loss, and personal events such as

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divorce or health problems. Property values are subject to volatility and may be affected adversely by a number of factors, including, but not limited to, national, regional, and local economic conditions (which may be adversely affected by industry slowdowns and other factors), local real estate conditions (such as an oversupply of housing), changes or continued weakness in specific industry segments, construction quality, age and design, demographic factors, and retroactive changes to building or similar codes. For mortgage-related instruments, the two primary components of credit risk are default risk and severity risk.

#### Default Risk

Default risk is the risk that borrowers will fail to make principal and interest payments on their mortgage loans. Subject to qualifying and maintaining our qualification as a REIT and our exemption from registration under the Investment Company Act, we may selectively attempt to mitigate our default risk by, among other things, opportunistically entering into credit default swaps and total return swaps. These instruments can reference various RMBS indices, corporate bond indices, or corporate entities, such as publicly traded REITs. We also rely on third-party mortgage servicers to mitigate our default risk, but such third-party mortgage servicers may have little or no economic incentive to mitigate loan default rates.

#### Severity Risk

Severity risk is the risk of loss upon a borrower default on a mortgage loan underlying our RMBS. Severity risk includes the risk of loss of value of the property underlying the mortgage loan as well as the risk of loss associated with taking over the property, including foreclosure costs. We rely on third-party mortgage servicers to mitigate our severity risk, but such third-party mortgage servicers may have little or no economic incentive to mitigate loan loss severities. Such mitigation efforts may include loan modification programs and prompt foreclosure and property liquidation following a default.

### Item 4. Controls and Procedures

#### Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and that such information is accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosures. An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of September 30, 2014. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2014.

#### Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the three month period ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

Neither we nor our Manager are currently subject to any legal proceedings that we or our Manager consider to be material. Nevertheless, at any time, industry-wide or company-specific regulatory inquiries or proceedings can be initiated and we cannot predict when or if any such regulatory inquiries or proceedings will be initiated that involve us, Ellington, or its affiliates, including our Manager. See "Risk Factors—We, Ellington, or its affiliates may be subject to regulatory inquiries or proceedings" included in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013. Ellington and its affiliates have, over the years, received, and we expect in the future that they may receive, inquiries and requests for documents and information from various regulators.

We can give no assurances that regulatory inquiries will not result in investigations of Ellington or its affiliates or enforcement actions, fines or penalties or the assertion of private litigation claims against Ellington or its affiliates. In the event regulatory inquiries were to result in investigations, enforcement actions, fines, penalties, or the assertion of private litigation claims against Ellington or its affiliates, our Manager's ability to perform its obligations to us under the Management Agreement between us and our Manager, or Ellington's ability to perform its obligations to our

Manager under the services agreement between Ellington and our Manager, could be adversely impacted, which could in turn have a material adverse effect on our business, financial condition and results of operations, and our ability to make distributions to our shareholders.

Item 1A. Risk Factors

For information regarding factors that could affect our results of operations, financial condition, and liquidity, see the risk factors discussed under "Risk Factors" in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no material changes from these previously disclosed risk factors. See also "Special Note Regarding Forward-Looking Statements," included in Part I, Item 2 of this Quarterly Report on Form 10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On September 11, 2014, we issued 2,358 restricted common shares to each of Robert B. Allardice, III, David Miller, Thomas Robards and Ronald I. Simon, Ph.D., as compensation for serving as trustees. These restricted share grants were made pursuant to our 2013 Equity Incentive Plan and such grants were exempt from the registration requirements of the Securities Act based on the exemption provided by Section 4(2) of the Securities Act.

Item 5. Other Information

Pursuant to Section 13(r) of the Exchange Act, if during the fiscal quarter ended September 30, 2014, we or any of our affiliates had engaged in certain transactions with Iran or with persons or entities designated under certain executive orders, we would be required to disclose information regarding such transactions in our Quarterly Report on Form 10-Q as required under Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012 ("ITRA"). During the fiscal quarter ended September 30, 2014, we did not engage in any transactions with Iran or with persons or entities related to Iran.

Blackstone Tactical Opportunities EARN Holdings L.L.C., an affiliate of The Blackstone Group L.P. ("Blackstone"), is a holder of approximately 28% of the outstanding equity interests of our Common Shares and has a representative on our Board of Trustees. Accordingly, Blackstone may be deemed an "affiliate" of us, as that term is defined in Exchange Act Rule 12b-2. We have received notice from Blackstone that it may include in its Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2014 disclosures pursuant to ITRA regarding one of its portfolio companies that may be deemed to be an affiliate of Blackstone. Because of the broad definition of "affiliate" in Exchange Act Rule 12b-2, this portfolio company of Blackstone, through Blackstone's ownership of us, may also be deemed to be an affiliate of ours.

We have reproduced below the disclosure of Travelport Limited, as provided to us by Blackstone. Travelport Limited may be considered an affiliate of Blackstone. We have no involvement in or control over the activities of Travelport Limited, any of its predecessor companies or any of its subsidiaries, and we have not independently verified or participated in the preparation of this disclosure.

"As part of our global business in the travel industry, we provide certain passenger travel-related GDS and Technology Services to Iran Air. We also provide certain Technology Services to Iran Air Tours. All of these services are either exempt from applicable sanctions prohibitions pursuant to a statutory exemption permitting transactions ordinarily incident to travel or, to the extent not otherwise exempt, specifically licensed by the U.S. Office of Foreign Assets Control. Subject to any changes in the exempt/licensed status of such activities, we intend to continue these business activities, which are directly related to and promote the arrangement of travel for individuals.

The gross revenue and net profit attributable to these activities in the quarter ended September 30, 2014 are still being determined."

Neither Travelport Limited nor Blackstone has provided us with gross revenues and net profits attributable to the activities described above.

Item 6. Exhibits

Exhibit	Description
10.1	Form of Share Award Agreement for September 11, 2014 awards
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes – Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes – Oxley Act of 2002
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes – Oxley Act of 2002
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes – Oxley Act of 2002
101	The following financial information from Ellington Residential Mortgage REIT's Quarterly Report on Form 10-Q for the three month period ended September 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheet, (ii) Consolidated Statement of Operations, (iii) Consolidated Statement of Shareholders' Equity, (iv) Consolidated Statement of Cash Flows and (v) Notes to Consolidated Financial Statements.

\*Furnished herewith. These certifications are not deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

SIGNATURES

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

Date: November 12, 2014

ELLINGTON RESIDENTIAL MORTGAGE REIT

By: /s/ LAURENCE PENN

Laurence Penn

Chief Executive Officer

(Principal Executive Officer)

Date: November 12, 2014

ELLINGTON RESIDENTIAL MORTGAGE REIT

By: /s/ LISA MUMFORD

Lisa Mumford

Chief Financial Officer

(Principal Financial and Accounting Officer)

EXHIBIT INDEX

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