

ANWORTH MORTGAGE ASSET CORP
Form 10-K
February 26, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2009

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 001-13709

ANWORTH MORTGAGE ASSET CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

MARYLAND
(State or Other Jurisdiction of incorporation or organization)

52-2059785
(I.R.S. Employer Identification No.)

1299 OCEAN AVENUE, SECOND FLOOR,
SANTA MONICA, CALIFORNIA
(Address of Principal Executive Offices)

90401
(Zip Code)

Registrant's telephone number, including area code: (310) 255-4493

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Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Series A Cumulative Preferred Stock, \$0.01 Par Value	New York Stock Exchange
Series B Cumulative Convertible Preferred	
Stock, \$0.01 Par Value	New York Stock Exchange
Common Stock, \$0.01 Par Value	New York Stock Exchange
Securities registered pursuant to Section 12(g) of the Act: NONE	

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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 that disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

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

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-Accelerated Filer ☐ Smaller Reporting Company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

The aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant, computed by reference to the closing price of such stock on the New York Stock Exchange, as of June 30, 2009 was approximately \$729,283,728.

As of February 23, 2010, the registrant had 116,742,130 shares of common stock issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of the Form 10-K incorporates by reference certain portions of the registrant's proxy statement for its 2010 annual meeting of stockholders to be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report.

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ANWORTH MORTGAGE ASSET CORPORATION

FORM 10-K ANNUAL REPORT

FISCAL YEAR ENDED DECEMBER 31, 2009

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CAUTIONARY STATEMENT

This Annual Report on Form 10-K contains or incorporates by reference certain forward-looking statements. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words will, believe, expect, anticipate, intend, estimate, assume or other similar expressions. You should not rely on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. These forward-looking statements are subject to assumptions, various risks and uncertainties that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, some of which are listed under the section Risk Factors, Item 1A of this Annual Report on Form 10-K. We undertake no obligation and have no present intention to revise or update publicly any forward-looking statements for any reason.

As used in this Annual Report on Form 10-K, company, we, us, our and Anworth refer to Anworth Mortgage Asset Corporation.

PART I

Item 1. BUSINESS
Overview

We were formed in October 1997 and commenced operations on March 17, 1998. We are in the business of investing primarily in United States, or U.S., agency mortgage-backed securities, or MBS, which are obligations guaranteed by the U.S. government, such as Ginnie Mae, or federally sponsored enterprises, such as Fannie Mae or Freddie Mac. Our principal business objective is to generate net income for distribution to stockholders based upon the spread between the interest income on our mortgage-related assets and the costs of borrowing to finance our acquisition of these assets.

We are organized for tax purposes as a real estate investment trust, or REIT. Accordingly, we generally distribute substantially all of our earnings to stockholders without paying federal or state income tax at the corporate level on the distributed earnings. At December 31, 2009, our qualified REIT assets (real estate assets, as defined under the Internal Revenue Code of 1986, or the Code, cash and cash items and government securities) were greater than 90% of our total assets, as compared to the Code requirement that at least 75% of our total assets must be qualified REIT assets. Greater than 99% of our 2009 revenue qualifies for both the 75% source of income test and the 95% source of income test under the REIT rules. We believe we met all REIT requirements regarding the ownership of our common stock and the distributions of our net income. Therefore, we believe that we continue to qualify as a REIT under the provisions of the Code.

During the past year, the credit and liquidity problems surrounding the mortgage markets and impacting the general economy have continued. This, along with other factors, has created great uncertainty in the financial markets in general and the related general economic recession. General downward economic trends, reduced availability of credit, increased unemployment and concerns over the economy have continued.

Although the U.S. government and other governments have taken various actions (including placing Fannie Mae and Freddie Mac in conservatorship) intended to protect financial institutions, their respective economies and their respective housing and mortgage markets, we continue to operate under very difficult market conditions. There can be no assurance that these various actions will have a beneficial impact on the global financial markets and, more specifically, the market for the securities we currently own in our portfolio. We cannot predict what, if any, impact these actions or future actions by either the U.S. government or foreign governments could have on our business, results of operations and financial condition. These events may impact

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the availability of financing generally in the marketplace and also may impact the market value of MBS generally, including the securities we currently own in our portfolio.

Our continuing operations consist of the following portfolios: Agency mortgage-backed securities, or Agency MBS, and Non-Agency mortgage-backed securities, or Non-Agency MBS. Approximately 99.9% of our total portfolio is Agency MBS.

At December 31, 2009, we had total assets of \$6.53 billion. Our Agency MBS portfolio, consisting of \$6.49 billion, was distributed as follows: 25% adjustable-rate Agency MBS, 62% hybrid adjustable-rate Agency MBS, 13% fixed-rate Agency MBS and less than 1% agency floating-rate collateralized mortgage obligations, or CMOs. Our Non-Agency MBS portfolio consisted of approximately \$4.7 million of floating-rate CMOs. Stockholders' equity available to common stockholders at December 31, 2009 was approximately \$854.7 million, or \$7.40 per share. The \$854.7 million equals total stockholders' equity of \$903.5 million less the Series A Cumulative Preferred Stock, or Series A Preferred Stock, liquidating value of \$46.9 million and less the difference between the Series B Cumulative Convertible Preferred Stock, or Series B Preferred Stock, liquidating value of \$27.7 million and the proceeds from its sale of \$25.8 million. For the year ended December 31, 2009, we reported net income of \$130.2 million. Net income to common stockholders was \$124.3 million, or net income of \$1.16 per diluted share, based on a weighted average of 108.9 million fully diluted shares outstanding. Net income to common stockholders consists of net income of \$130.2 million minus payment of preferred dividends of \$5.9 million.

Our Strategy

Investment Strategy

Our strategy is to invest primarily in Agency MBS. We seek to acquire assets that will produce competitive returns after considering the amount and nature of the investment's anticipated returns, our ability to pledge the investment to secure collateralized borrowings and the costs associated with financing, managing and reserving for these investments. We do not currently originate mortgage loans or provide other types of financing to the owners of real estate.

Financing Strategy

We primarily finance the acquisition of MBS with short-term borrowings and, to a lesser extent, equity capital. We employ short-term borrowing to attempt to increase potential returns to our stockholders. Pursuant to our Capital and Leverage Policy, we seek to strike a balance between the under-utilization of leverage, which reduces potential returns to stockholders, and the over-utilization of leverage, which could reduce our ability to meet our obligations during adverse market conditions.

We usually borrow at short-term rates using repurchase agreements. Repurchase agreements are generally short-term in nature (less than or equal to twelve months). We actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the adjustment periods and the selection of the interest rate indices on our mortgage-related assets in order to lessen the liquidity and interest rate-related risks. We generally seek to diversify our exposure by entering into repurchase agreements with multiple lenders which are approved by our board of directors. We are operating in an environment where, as a result of economic conditions, several large financial institutions involved in repurchase financing of MBS either have been acquired or filed bankruptcy, decreasing the number of potential repurchase agreement counterparties.

Growth Strategy

It is our long-term objective to further grow our earnings and our dividends per common share using various strategies which may include the following:

decreasing the ratio of operating expenses to stockholder equity by increasing the amount of our stockholder equity at a rate faster than the rate of increase in our operating expenses;

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issuing additional common shares when the net proceeds will materially increase the paid-in capital per share and the book value per share;

repurchasing outstanding common shares when the net cost will materially increase the paid-in capital per share and the book value per share; and

lowering our effective borrowing costs over time by seeking direct funding with collateralized lenders rather than using financial intermediaries and possibly using commercial paper, medium-term note programs, preferred stock and other forms of capital.

Our Operating Policies and Programs

We have established the following four primary operating policies to implement our business strategies:

our Asset Acquisition Policy;

our Capital and Leverage Policy;

our Credit Risk Management Policy; and

our Asset/Liability Management Policy.

Asset Acquisition Policy

Our Asset Acquisition Policy provides guidelines for acquiring investments and contemplates that we will acquire a portfolio of investments that can be grouped into specific categories. Each category and our respective investment guidelines are as follows:

Category I At least 60% of our total assets will generally be adjustable- or fixed-rate MBS and short-term investments. Assets in this category will be rated within one of the two highest rating categories by at least one nationally recognized statistical rating organization or, if not rated, will be obligations guaranteed by the U.S. government or its agencies, such as Fannie Mae or Freddie Mac. Also included in Category I are the portion of real estate mortgage loans that have been deposited into a trust and have received a rating within one of the two highest rating categories by at least one nationally recognized statistical rating organization.

Category II At least 90% of our total assets will generally consist of Category I investments plus unsecuritized mortgage loans, mortgage securities rated at least investment grade by at least one nationally recognized statistical rating organization, or shares of other REITs or mortgage-related companies and the portion of real estate mortgage loans that have been deposited into a trust and have received an investment grade rating by at least one nationally recognized statistical rating organization.

Category III No more than 10% of our total assets may be of a type not meeting any of the above criteria. Among the types of assets generally assigned to this category are mortgage securities rated below investment grade and leveraged mortgage derivative securities. Under our Category III investment criteria, we may acquire other types of mortgage derivative securities including, but not limited to, interest-only, principal-only or other types of MBS that receive a disproportionate share of interest income or principal.

Capital and Leverage Policy

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We employ a leverage strategy to increase our investment assets by borrowing against existing mortgage-related assets and using the proceeds to acquire additional mortgage-related assets. Relative to our investment in investment grade Agency MBS, we generally borrow, on a short-term basis, between seven to twelve times the amount of our equity allocated to these investments. During the past year, we have borrowed, on a short-term basis, between five to seven times the amount of our equity allocated to these investments, as management believed it to be appropriate to lower our leverage due to the uncertainty in the financial marketplace and the

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broader problems in the economy. Our borrowings may vary from time to time depending on market conditions and other factors deemed relevant by our management and our board of directors. We believe that this will leave an adequate capital base to protect against interest rate environments in which our borrowing costs might exceed our interest income from mortgage-related assets.

Depending on the different costs of borrowing funds at different maturities, we may vary the maturities of our borrowed funds in an attempt to produce lower borrowing costs. Our borrowings are short-term and we manage actively, on an aggregate basis, both the interest rate indices and interest rate adjustment periods of our borrowings against the interest rate indices and interest rate adjustment periods on our mortgage-related assets.

Our mortgage-related assets are financed primarily at short-term borrowing rates through repurchase agreements. In the future, we may also employ borrowings under lines of credit and other collateralized financings that we may establish with approved institutional lenders.

Credit Risk Management Policy

We review credit risk and other risks of loss associated with each of our potential investments. In addition, we may diversify our portfolio of mortgage-related assets to avoid undue geographic, insurer, industry and certain other types of concentrations.

Compliance with our Credit Risk Management Policy guidelines is determined at the time of purchase of mortgage assets based upon the most recent valuation utilized by us. Such compliance is not affected by events subsequent to such purchase including, without limitation, changes in characterization, value or rating of any specific mortgage assets or economic conditions or events generally affecting any mortgage-related assets of the type held by us.

Asset/Liability Management Policy

Interest Rate Risk Management. To the extent consistent with our election to qualify as a REIT, we follow an interest rate risk management program intended to protect our portfolio of mortgage-related assets and related debt against the effects of major interest rate changes. Specifically, our interest rate management program is formulated with the intent to offset, to some extent, the potential adverse effects resulting from rate adjustment limitations on our mortgage-related assets and the differences between interest rate adjustment indices and interest rate adjustment periods of our adjustable-rate mortgage-related assets and related borrowings.

Our interest rate risk management program encompasses a number of procedures including the following:

monitoring and adjusting, if necessary, the interest rate sensitivity of our mortgage-related assets compared with the interest rate sensitivities of our borrowings;

attempting to structure our borrowing agreements relating to adjustable-rate mortgage-related assets to have a range of different maturities and interest rate adjustment periods (although substantially all will be less than one year); and

actively managing, on an aggregate basis, the interest rate indices and interest rate adjustment periods of our mortgage-related assets compared to the interest rate indices and adjustment periods of our borrowings.

We expect to be able to adjust the average maturity/adjustment period of our borrowings on an ongoing basis by changing the mix of maturities and interest rate adjustment periods as borrowings come due or are renewed. Through the use of these procedures, we attempt to reduce the risk of differences between interest rate adjustment periods of our adjustable-rate mortgage-related assets and our related borrowings.

Depending on market conditions and the cost of the transactions, we may conduct certain hedging activities in connection with the management of our portfolio. To the extent consistent with our election to qualify as a

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REIT, we may adopt a hedging strategy intended to lessen the effects of interest rate changes and to enable us to earn net interest income in periods of generally rising, as well as declining or static, interest rates. Specifically, hedging programs are formulated with the intent to offset some of the potential adverse effects of changes in interest rate levels relative to the interest rates on the mortgage-related assets held in our investment portfolio and differences between the interest rate adjustment indices and periods of our mortgage-related assets and our borrowings. We monitor carefully, and may have to limit, our hedging activity to assure that we do not realize excessive hedging income or hold hedges having excess value in relation to mortgage-related assets, which could result in our disqualification as a REIT or, in the case of excess hedging income, if the excess is due to reasonable cause and not willful neglect, the payment of a penalty tax for failure to satisfy certain REIT income tests under the Code. In addition, hedging activity involves transaction costs that increase dramatically as the period covered by hedging protection increases and that may increase during periods of fluctuating interest rates.

Prepayment Risk Management. We also seek to lessen the effects of prepayment of mortgage loans underlying our securities at a faster or slower rate than anticipated. We accomplish this by structuring a diversified portfolio with a variety of prepayment characteristics, investing in mortgage-related assets with prepayment prohibitions and penalties, investing in certain mortgage security structures that have prepayment protections and purchasing mortgage-related assets at a premium or at a discount. We invest in mortgage-related assets that, on a portfolio basis, do not have significant purchase price premiums. Under normal market conditions, we seek to maintain the aggregate capitalized purchase premium of the portfolio at 3% or less. In addition, we can purchase principal-only derivatives to a limited extent as a hedge against prepayment risks. We monitor prepayment risk through periodic review of the impact of a variety of prepayment scenarios on our revenues, net earnings, dividends, cash flow and net consolidated balance sheets market value.

We believe that we have developed cost-effective asset/liability management policies to mitigate prepayment risks. However, no strategy can completely insulate us from prepayment risks. Further, as noted above, certain of the federal income tax requirements that we must satisfy to qualify as a REIT limit our ability to fully hedge our prepayment risks. Therefore, we could be prevented from effectively hedging our prepayment risks.

Our Investments

Mortgage-Backed Securities (MBS)

Pass-Through Certificates. We principally invest in pass-through certificates, which are securities representing interests in pools of mortgage loans secured by residential real property in which payments of both interest and principal on the securities are generally made monthly, in effect, passing through monthly payments made by the individual borrowers on the mortgage loans which underlie the securities, net of fees paid to the issuer or guarantor of the securities. Early repayment of principal on some MBS, arising from prepayments of principal due to sale of the underlying property, refinancing or foreclosure, net of fees and costs which may be incurred, may expose us to a lower rate of return upon reinvestment of principal. This is generally referred to as prepayment risk. Additionally, if a security subject to prepayment has been purchased at a premium, the unamortized value of the premium would be lost in the event of prepayment.

Like other fixed-income securities, when interest rates rise, the value of a mortgage-backed security generally will decline. When interest rates are declining, however, the value of MBS with prepayment features may not increase as much as other fixed-income securities. The rate of prepayments on underlying mortgages will affect the price and volatility of MBS and may have the effect of shortening or extending the effective maturity of the security beyond what was anticipated at the time of purchase. When interest rates rise, our holdings of MBS may experience reduced returns if the owners of the underlying mortgages pay off their mortgages later than anticipated. This is generally referred to as extension risk.

Payment of principal and interest on some mortgage pass-through securities, though not the market value of the securities themselves, may be guaranteed by the full faith and credit of the federal government, including securities backed by Ginnie Mae, or by agencies or instrumentalities of the federal government, including Fannie

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Mae and Freddie Mac. MBS created by non-governmental issuers, including commercial banks, savings and loan institutions, private mortgage insurance companies, mortgage bankers and other secondary market issuers, may be supported by various forms of insurance or guarantees including individual loan, title, pool and hazard insurance and letters of credit which may be issued by governmental entities, private insurers or the mortgage poolers. Approximately 99.9% of our portfolio is Agency MBS.

Collateralized Mortgage Obligations. CMOs are MBS. Interest and principal on CMOs are paid, in most cases, on a monthly basis. CMOs may be collateralized by whole mortgage loans, but are more typically collateralized by portfolios of mortgage pass-through securities. CMOs are structured into multiple classes with each class bearing a different stated maturity. Monthly payments of principal, including prepayments, are first returned to investors holding the shortest maturity class; investors holding the longer maturity classes receive principal only after the first class has been retired. We will typically consider investments in CMOs that are issued or guaranteed by the federal government, or by any of its agencies or instrumentalities, to be U.S. government securities.

Other Types of MBS

Mortgage Derivative Securities. We may acquire mortgage derivative securities in an amount not to exceed 10% of our total assets. Mortgage derivative securities provide for the holder to receive interest-only, principal-only or interest and principal in amounts that are disproportionate to those payable on the underlying mortgage loans. Payments on mortgage derivative securities are highly sensitive to the rate of prepayments on the underlying mortgage loans. In the event of faster or slower than anticipated prepayments on these mortgage loans, the rates of return on interests in mortgage derivative securities, representing the right to receive interest-only or a disproportionately large amount of interest or interest-only derivatives, would be likely to decline or increase, respectively. Conversely, the rates of return on mortgage derivative securities, representing the right to receive principal-only or a disproportionate amount of principal or principal-only derivatives, would be likely to increase or decrease in the event of faster or slower prepayments, respectively.

We may invest in inverse floaters, a class of CMOs with a coupon rate that resets in the opposite direction from the market rate of interest to which it is indexed, including LIBOR or the 11th District Cost of Funds Index, or COFI. Any rise in the index rate, which can be caused by an increase in interest rates, causes a drop in the coupon rate of an inverse floater, while any drop in the index rate causes an increase in the coupon of an inverse floater. An inverse floater may behave like a leveraged security since its interest rate usually varies by a magnitude much greater than the magnitude of the index rate of interest. The leverage-like characteristics inherent in inverse floaters result in a greater volatility of their market prices.

We may invest in other mortgage derivative securities that may be developed in the future.

Mortgage Warehouse Participations. We may occasionally acquire mortgage warehouse participations as an additional means of diversifying our sources of income. We anticipate that these investments, together with our investments in other Category III assets, will not in the aggregate exceed 10% of our total mortgage-related assets. These investments are participations in lines of credit to mortgage loan originators secured by recently originated mortgage loans that are in the process of being sold to investors. Our investments in mortgage warehouse participations are limited because they are not qualified REIT assets under the Code.

Other Mortgage-Related Assets

We may acquire other investments that include equity and debt securities issued by other primarily mortgage-related finance companies, interests in mortgage-related collateralized bond obligations, other subordinated interests in pools of mortgage-related assets, commercial mortgage loans and securities and residential mortgage loans other than high-credit quality mortgage loans. Although we expect that our other investments will be limited to less than 10% of total assets, we have no limit on how much of our stockholders' equity will be allocated to other investments. There may be periods in which other investments represent a large portion of our stockholders' equity.

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Competition

When we invest in Agency MBS, we compete with a variety of institutional investors including other REITs, insurance companies, mutual funds, pension funds, investment banking firms, banks and other financial institutions that invest in the same or similar types of assets. Many of these investors have greater financial resources and access to lower costs of capital than we do.

Employees

As of December 31, 2009, Anworth had twelve employees, seven of whom were part-time.

Company Information

We were incorporated in Maryland on October 20, 1997 and commenced our operations on March 17, 1998. Our principal executive offices are located at 1299 Ocean Avenue, Second Floor, Santa Monica, California, 90401. Our telephone number is (310) 255-4493 and our fax number is (310) 434-0070.

Information on our Company Website

The Company maintains a website, <http://www.anworth.com>. We make our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act available, free of charge, on our website as soon as reasonably practicable after we file or furnish these reports with the United States Securities and Exchange Commission, or the SEC. In addition, we post the following information on our website (the Company does not intend to and does not hereby incorporate by reference the information on our website as a part of this Annual Report on Form 10-K):

our corporate code of conduct, which qualifies as a code of ethics as defined by Item 406 of Regulation S-K of the Securities Exchange Act of 1934;

our corporate governance guidelines; and

charters for our Audit Committee, Nominating and Corporate Governance Committee and Compensation Committee.

All of the above information is also available in print upon request to our secretary at the address listed under the heading Company Information above.

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CERTAIN FEDERAL INCOME TAX CONSIDERATIONS

The following discussion summarizes particular U.S. federal income tax considerations regarding our qualification and taxation as a REIT and particular U.S. federal income tax consequences resulting from the acquisition, ownership and disposition of our capital stock. This discussion is based on current law and assumes that we have qualified at all times throughout our existence, and will continue to qualify, as a REIT for U.S. federal income tax purposes. The tax law upon which this discussion is based could be changed and any such change could have a retroactive effect. The following discussion is not exhaustive of all possible tax considerations. This summary neither gives a detailed discussion of any state, local or foreign tax considerations nor discusses all of the aspects of U.S. federal income taxation that may be relevant to you in light of your particular circumstances or to particular types of stockholders which are subject to special tax rules, such as insurance companies, tax-exempt entities, financial institutions or broker-dealers, foreign corporations or partnerships and persons who are not citizens or residents of the U.S., stockholders that hold our stock as a hedge, part of a straddle, conversion transaction or other arrangement involving more than one position, or stockholders whose functional currency is not the U.S. dollar. This discussion assumes that you will hold our capital stock as a capital asset, generally property held for investment, under the Code.

We urge you to consult with your own tax advisor regarding the specific consequences to you of the acquisition, ownership and disposition of stock in an entity electing to be taxed as a REIT, including the federal, state, local, foreign and other tax considerations of such acquisition, ownership, disposition and election and the potential changes in applicable tax laws.

General

Our qualification and taxation as a REIT depends upon our ability to continue to meet the various qualification tests, imposed under the Code and discussed below, relating to our actual annual operating results, asset diversification, distribution levels and diversity of stock ownership. Accordingly, the actual results of our operations for any particular taxable year may not satisfy these requirements.

We have made an election to be taxed as a REIT under the Code commencing with our taxable year ended December 31, 1998. We currently expect to continue operating in a manner that will permit us to maintain our qualification as a REIT. All qualification requirements for maintaining our REIT status, however, may not have been, or might not continue to be, met.

So long as we qualify for taxation as a REIT, we generally will be permitted a deduction for dividends we pay to our stockholders. As a result, we generally will not be required to pay federal corporate income taxes on our net income that is currently distributed to our stockholders. This treatment substantially eliminates the double taxation that ordinarily results from investment in a corporation. Double taxation means taxation once at the corporate level when income is earned and once again at the stockholder level when this income is distributed. We will be required to pay federal income tax, however, as follows:

we will be required to pay tax at regular corporate rates on any undistributed real estate investment trust taxable income, including undistributed net capital gains;

we may be required to pay the alternative minimum tax on our items of tax preference; and

if we have (a) net income from the sale or other disposition of foreclosure property which is held primarily for sale to customers in the ordinary course of business, or (b) other non-qualifying income from foreclosure property, we will be required to pay tax at the highest corporate rate on this income. Foreclosure property is generally defined as property acquired through foreclosure or after a default on a loan secured by the property or on a lease of the property.

To the extent that distributions exceed current and accumulated earnings and profits, they will constitute a return of capital, rather than dividend or capital gain income, and will reduce the basis for the stockholder's stock with respect to which the distributions are paid or, to the extent that they exceed such basis, will be taxed in the

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same manner as gain from the sale of that stock. For purposes of determining whether distributions are out of current or accumulated earnings and profits, our earnings and profits will be allocated first to our preferred stock (as compared to distributions with respect to our common stock) so that distributions with respect to our preferred stock are more likely to be treated as dividends than as return of capital or a distribution in excess of basis. Calculations of corporate earnings and profits are complex, and it is possible that distributions expected to be a return of capital may subsequently be determined to be taxable distributions of earnings and profits.

Dividends paid by regular C corporations to stockholders other than corporations now are generally taxed at the rate applicable to long-term capital gains, which is a maximum of 15%, subject to certain limitations. Because we are a REIT, however, our dividends, including dividends paid on our Series A Preferred Stock and Series B Preferred Stock, generally will continue to be taxed at regular ordinary income tax rates, except in limited circumstances.

We will be required to pay a 100% tax on any net income from prohibited transactions. Prohibited transactions are, in general, sales or other taxable dispositions of property other than foreclosure property held primarily for sale to customers in the ordinary course of business. Under existing law, whether property is held as inventory or primarily for sale to customers in the ordinary course of a trade or business depends on all the facts and circumstances surrounding the particular transaction.

If we fail to satisfy the 75% gross income test or the 95% gross income test discussed below but nonetheless maintain our qualification as a REIT because certain other requirements are met, we will be subject to a tax equal to:

the greater of (i) the amount by which 75% of our gross income exceeds the amount qualifying under the 75% gross income test described below, and (ii) the amount by which 95% of our gross income exceeds the amount qualifying under the 95% gross income test described below, multiplied by a fraction intended to reflect our profitability.

In the event of more than de minimis failure of any of the asset tests occurs in a taxable year, as long as the failure was due to reasonable cause and not to willful neglect and we dispose of the assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure, we will pay a tax equal to the greater of \$50 thousand or 35% of the net income from the non-qualifying assets during the period in which we failed to satisfy any of the asset tests.

In the event of a failure to satisfy one or more requirements for REIT qualification occurring in a taxable year, other than the gross income tests and the asset tests, as long as such failure was due to reasonable cause and not to willful neglect, we will be required to pay a penalty of \$50 thousand for each such failure.

We will be required to pay a nondeductible 4% excise tax on the excess of the required distribution over the amounts actually distributed if we fail to distribute during each calendar year at least the sum of:

85% of our real estate investment trust ordinary income for the year;

95% of our real estate investment trust capital gain net income for the year; and

any undistributed taxable income from prior periods.

This distribution requirement is in addition to, and different from, the distribution requirements discussed below in the section entitled Annual Distribution Requirements.

We may elect to retain and pay income tax on our net long-term capital gain. In that case, a U.S. stockholder would be taxed on its proportionate share of our undistributed long-term capital gain (to the extent that we make a timely designation of such gain to the stockholder) and would receive a credit or refund of its proportionate share of the tax we paid. The basis of the stockholder's shares is increased by the amount of the undistributed long-term capital gain (less the amount of capital gains tax paid by the REIT) included in the stockholder's long-term capital gains.

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If we own a residual interest in a REMIC, we will be taxable at the highest corporate rate on the portion of any excess inclusion income that we derive from the REMIC residual interests equal to the percentage of our stock that is held by disqualified organizations. Although the law is unclear, similar rules may apply if we own an equity interest in a taxable mortgage pool. To the extent that we own a REMIC residual interest in a taxable mortgage pool through a taxable REIT subsidiary, we will not be subject to tax. A disqualified organization includes:

the U.S.;

any state or political subdivision of the U.S.;

any foreign government;

any international organization;

any agency or instrumentality of any of the foregoing;

any other tax-exempt organization other than a farmers' cooperative described in Section 521 of the Code that is exempt both from income taxation and from taxation under the unrelated business taxable income provisions of the Code; and

any rural electrical or telephone cooperative.

If we acquire any asset from a corporation which is or has been taxed as a C corporation under the Code in a transaction in which the basis of the asset in our hands is determined by reference to the basis of the asset in the hands of the C corporation and we subsequently recognize gain on the disposition of the asset during the ten-year period beginning on the date on which we acquired the asset, then we will be required to pay tax at the highest regular corporate tax rate on this gain to the extent of the excess of:

the fair market value of the asset, over

our adjusted basis in the asset,

in each case determined as of the date on which we acquired the asset.

A C corporation is generally defined as a corporation required to pay full corporate-level tax. The results described in the preceding paragraph with respect to the recognition of gain will apply unless we make an election under Treasury Regulation Section 1.337(d)-7(c). If such an election were made, the C corporation would recognize taxable gain or loss as if it had sold the assets we acquired from the C corporation to an unrelated third party at fair market value on the acquisition date.

We will be subject to a 100% excise tax if our dealings with any taxable REIT subsidiaries (defined below) are not at arm's length.

In addition, notwithstanding our REIT status, we may also have to pay certain state and local income taxes, because not all states and localities treat REITs in the same manner as they are treated for federal income tax purposes.

Requirements for Qualification as a REIT

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The Code defines a REIT as a corporation, trust or association:

1. that is managed by one or more trustees or directors;
2. that issues transferable shares or transferable certificates to evidence beneficial ownership;
3. that would be taxable as a domestic corporation but for Code Sections 856 through 859;
4. that is not a financial institution or an insurance company within the meaning of the Code;
5. that is beneficially owned by 100 or more persons;

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6. that not more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals, including specified entities, during the last half of each taxable year;
7. that meets other tests, described below, regarding the nature of its income and assets and the amount of its distributions; and
8. that elects to be a REIT or has made such election for a previous taxable year and satisfies all relevant filing and other administrative requirements established by the Internal Revenue Service, or the IRS, that must be met to elect and retain REIT status.

The Code provides that all of the first four conditions stated above must be met during the entire taxable year and that the fifth condition must be met during at least 335 days of a taxable year of twelve months, or during a proportionate part of a taxable year of less than twelve months. The fifth and sixth conditions do not apply until after the first taxable year for which an election is made to be taxed as a REIT.

For purposes of the sixth condition, pension trusts and other specified tax-exempt entities generally are treated as individuals, except that a look-through exception generally applies with respect to pension funds.

Stock Ownership Tests

Our stock must be beneficially held by at least 100 persons, the 100 Stockholder Rule, and no more than 50% of the value of our stock may be owned, directly or indirectly, by five or fewer individuals at any time during the last half of the taxable year, the 5/50 Rule. For purposes of the 100 Stockholder Rule only, trusts described in Section 401(a) of the Code and exempt under Section 501(a) of the Code are generally treated as persons. These stock ownership requirements must be satisfied in each taxable year other than the first taxable year for which an election is made to be taxed as a REIT. We are required to solicit information from certain of our record stockholders to verify actual stock ownership levels and our charter provides for restrictions regarding the transfer of our stock in order to aid in meeting the stock ownership requirements. If we were to fail either of the stock ownership tests, we would generally be disqualified from our REIT status. However, if we comply with regulatory rules pursuant to which we are required to send annual letters to holders of our stock requesting information regarding the actual ownership of our stock, and we do not know, or exercising reasonable diligence would not have known, whether we failed to meet the 5/50 Rule, we will be treated as having met the 5/50 Rule.

Income Tests

We must satisfy two gross income requirements annually to maintain our qualification as a REIT:

We must derive, directly or indirectly, at least 75% of our gross income, excluding gross income from prohibited transactions, from specified real estate sources, including rental income, interest on obligations secured by mortgages on real property or on interests in real property, gain from the disposition of qualified real estate assets, i.e., interests in real property, mortgages secured by real property or interests in real property, and some other assets, income from certain types of temporary investments, amounts, such as commitment fees, received in consideration for entering into an agreement to make a loan secured by real property, unless such amounts are determined by income and profits, and income derived from a REMIC in proportion to the real estate assets held by the REMIC, unless at least 95% of the REMIC's assets are real estate assets (in which case, all of the income derived from the REMIC), or the 75% gross income test; and

We must derive at least 95% of our gross income, excluding gross income from prohibited transactions, from (a) the sources of income that satisfy the 75% gross income test, (b) dividends, interest and gain from the sale or disposition of stock or securities, or (c) any combination of the foregoing, or the 95% gross income test.

Gross income from servicing loans for third parties and loan origination fees is not qualifying income for purposes of either gross income test. Gross income from our sale of property that we hold primarily for sale to

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customers in the ordinary course of business is excluded from both the numerator and the denominator in both income tests. Income and gain from certain transactions that we enter into to hedge indebtedness incurred or to be incurred to acquire or carry real estate assets, and that are clearly and timely identified as such, are excluded from both the numerator and denominator for purposes of the 95% gross income test and, for certain hedging transactions entered into after July 30, 2008, the 75% gross income test.

For purposes of the 75% and 95% gross income tests, a REIT is deemed to have earned a proportionate share of the income earned by any partnership, or any limited liability company treated as a partnership for federal income tax purposes, in which it owns an interest, which share is determined by reference to its capital interest in such entity, and is deemed to have earned the income earned by any qualified REIT subsidiary (in general, a 100%-owned corporate subsidiary of a REIT). Interest earned by a REIT ordinarily does not qualify as income meeting the 75% or 95% gross income tests if the determination of all or some of the amount of interest depends in any way on the income or profits of any person. Interest will not be disqualified from meeting such tests, however, solely by reason of being based on a fixed percentage or percentages of receipts or sales.

The following paragraphs discuss in more detail the specific application of the gross income tests to us.

Interest. The term interest, as defined for purposes of both gross income tests, generally excludes any amount that is based in whole or in part on the income or profits of any person. However, interest generally includes the following:

an amount that is based on a fixed percentage or percentages of receipts or sales; and

an amount that is based on the income or profits of a debtor as long as the debtor derives substantially all of its income from the real property securing the debt from leasing substantially all of its interest in the property and only to the extent that the amounts received by the debtor would be qualifying rents from real property if received directly by a REIT.

If a loan contains a provision that entitles a REIT to a percentage of the borrower's gain upon the sale of the real property securing the loan or a percentage of the appreciation in the property's value as of a specific date, income attributable to that loan provision will be treated as gain from the sale of the property securing the loan, which generally is qualifying income for purposes of both gross income tests.

Interest on debt secured by a mortgage on real property or on interests in real property, including, for this purpose, discount points, prepayment penalties, loan assumption fees and late payment charges that are not compensation for services, generally is qualifying income for purposes of the 75% gross income test. However, if the highest principal amount of a loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan as of the date the REIT agreed to originate or acquire the loan, a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test but will be qualifying income for purposes of the 95% gross income test. The portion of the interest income that will not be qualifying income for purposes of the 75% gross income test will be equal to the portion of the principal amount of the loan that is not secured by real property—that is, the amount by which the loan exceeds the value of the real estate that is security for the loan.

The interest, original issue discount and market discount income that we receive from our mortgage loans and MBS generally will be qualifying income for purposes of both gross income tests. However, as discussed above, if the fair market value of the real estate securing any of our loans is less than the principal amount of the loan, a portion of the income from that loan will be qualifying income for purposes of the 95% gross income test but not the 75% gross income test.

Fee Income. We may receive various fees in connection with originating mortgage loans. The fees will be qualifying income for purposes of both the 75% and 95% income tests if they are received in consideration for entering into an agreement to make a loan secured by real property and the fees are not determined based on the

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borrower's income or profits. Therefore, commitment fees will generally be qualifying income for purposes of the income tests. Other fees, such as fees received for servicing loans for third parties and origination fees, are not qualifying income for purposes of either income test.

Dividends. Our share of any dividends received from any corporation (including any of our taxable REIT subsidiaries, but excluding any REIT) in which we own an equity interest will qualify for purposes of the 95% gross income test but not for purposes of the 75% gross income test. Our share of any dividends received from any other REIT in which we own an equity interest will be qualifying income for purposes of both gross income tests.

Rents from Real Property. We do not intend to acquire any real property, but we may acquire real property or an interest therein in the future. To the extent that we acquire real property or an interest therein, rents we receive will qualify as rents from real property in satisfying the gross income requirements for a REIT described above only if the following conditions are met:

First, the amount of rent must not be based, in whole or in part, on the income or profits of any person. However, an amount received or accrued generally will not be excluded from rents from real property solely by reason of being based on fixed percentages of receipts or sales.

Second, rents we receive from a related party tenant will not qualify as rents from real property in satisfying the gross income tests unless the tenant is a taxable REIT subsidiary, at least 90% of the property is leased to unrelated tenants and the rent paid by the taxable REIT subsidiary is substantially comparable to the rent paid by the unrelated tenants for comparable space. A tenant is a related party tenant if the REIT, or an actual or constructive owner of 10% or more of the REIT, actually or constructively owns 10% or more of the tenant.

Third, if rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as rents from real property.

Fourth, we generally must not operate or manage our real property or furnish or render services to our tenants, other than through an independent contractor who is adequately compensated and from whom we do not derive revenue. However, we may provide services directly to tenants if the services are usually or customarily rendered in connection with the rental of space for occupancy only and are not considered to be provided for the tenants' convenience. In addition, we may provide a minimal amount of non-customary services to the tenants of a property, other than through an independent contractor, as long as our income from the services does not exceed 1% of our income from the related property. Furthermore, we may own up to 100% of the stock of a taxable REIT subsidiary, which may provide customary and non-customary services to tenants without tainting its rental income from the related properties.

Hedging Transactions. From time to time, we may enter into hedging transactions with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps and floors, options to purchase these items and futures and forward contracts. Income and gain from hedging transactions will be excluded from gross income for purposes of the 95% gross income test and, for certain hedging transactions entered into after July 30, 2008, the 75% gross income test. A hedging transaction includes any transaction entered into in the normal course of our trade or business primarily to manage the risk of interest rate, price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, to acquire or carry real estate assets. We will be required to clearly identify any such hedging transaction before the close of the day on which it was acquired, originated or entered into. To the extent that we hedge for other purposes, or to the extent that a portion of our mortgage loans is not secured by real estate assets (as described below under *Asset Tests*), or in other situations, the income from those transactions is not likely to be treated as qualifying income for purposes of the 95% gross income test. We intend to structure any hedging transactions in a manner that does not jeopardize our status as a REIT.

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Prohibited Transactions. A REIT will incur a 100% tax on the net income derived from any sale or other disposition of property other than foreclosure property that the REIT holds primarily for sale to customers in the ordinary course of a trade or business. We believe that none of our assets will be held primarily for sale to customers and that a sale of any of our assets will not be in the ordinary course of our business. Whether a REIT holds an asset primarily for sale to customers in the ordinary course of a trade or business depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. Nevertheless, we will attempt to comply with the terms of safe-harbor provisions in the federal income tax laws prescribing when an asset sale will not be characterized as a prohibited transaction.

Foreign currency gain or loss that is attributable to any prohibited transaction is taken into account in determining the amount of prohibited transaction net income subject to the 100% tax.

Foreclosure Property. We will be subject to tax at the maximum corporate rate on any income from foreclosure property other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. However, gross income from foreclosure property will qualify under the 75% and 95% gross income tests. Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

that is acquired by a REIT as the result of the REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;

for which the related loan or lease was acquired by the REIT at a time when the default was not imminent or anticipated; and

for which the REIT makes a proper election to treat the property as foreclosure property.

Permitted foreclosure property income also includes foreign currency gain that is attributable to otherwise permitted income from foreclosure property. Such foreign currency gain also is included as foreclosure property income for purposes of any tax on such income.

However, a REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor. Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;

on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or

which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT other than through an independent contractor from whom the REIT itself does not derive or receive any income.

Failure to Satisfy Gross Income Tests. If we fail to satisfy one or both of the gross income tests for any taxable year, we nevertheless may qualify as a REIT for that year if we qualify for relief under certain provisions of the federal income tax laws. Those relief provisions will be available if:

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our failure to meet those tests is due to reasonable cause and not to willful neglect, and

following such failure for any taxable year, a schedule of the sources of our income is filed in accordance with regulations prescribed by the Secretary of the Treasury.

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We cannot predict, however, whether in all circumstances we would qualify for the relief provisions. In addition, as discussed above, even if the relief provisions apply, we would incur a 100% tax on the gross income attributable to the greater of (i) the amount by which we fail the 75% gross income test or (ii) the amount by which 95% of our gross income exceeds the amount of our income qualifying under the 95% gross income test, multiplied, in either case, by a fraction intended to reflect our profitability.

Foreign Investment and Exchange Gains

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign-based assets, provided the 75% and 95% income tests and other requirements for REIT qualification are met. A REIT that holds foreign real estate or other foreign-based assets may have foreign currency exchange gain under the foreign currency transaction tax rules. Foreign currency exchange gain was not explicitly included in the statutory definitions of qualifying income for purposes of the 75% and 95% income tests until a recent statutory change, although the IRS issued guidance that allowed foreign currency gain to be treated as qualified income in certain circumstances.

For transactions occurring after July 30, 2008, the new provision excludes certain foreign currency gain from the computation of qualifying income for purposes of the 75% income test or the 95% income test, respectively. The exclusion is solely for purposes of the computations under these tests.

The statutory change defines two new categories of income for purposes of the exclusion rules: real estate foreign exchange gain and passive foreign exchange gain. Real estate foreign exchange gain is excluded from gross income for purposes of both the 75% and the 95% income tests. Passive foreign exchange gain is excluded for purposes of the 95% income test but is included in gross income and treated as non-qualifying income, to the extent that it is not real estate foreign exchange gain, for purposes of the 75% income test.

Real estate foreign exchange gain is foreign currency gain which is attributable to: (i) any item of income qualifying for the numerator for the 75% income test; (ii) the acquisition or ownership of obligations secured by mortgages on real property or interests in real property; or (iii) becoming or being the obligor under obligations secured by mortgages on real property or interests in real property. Real estate foreign exchange gain also includes certain foreign currency gains attributable to certain qualified business units of the REIT.

Passive foreign exchange gain includes all real estate foreign exchange and, in addition, includes foreign currency gain which is attributable to: (i) any item of income or gain included in the numerator for the 95% income test, (ii) acquisition or ownership of obligations other than described in the preceding paragraph; (iii) becoming the obligor under obligations other than described in the preceding paragraph; and (iv) any other foreign currency gain to be determined by the IRS.

Notwithstanding the foregoing rules, except in the case of certain income excluded under the hedging rules, foreign currency exchange gain derived from engaging in dealing, or substantial and regular trading, in certain securities shall constitute gross income that does not qualify under either the 75% or 95% income test.

Asset Tests

To qualify as a REIT, we also must satisfy the following asset tests at the end of each quarter of each taxable year:

First, at least 75% of the value of our total assets must consist of:

cash or cash items, including certain receivables;

government securities;

interests in real property, including leaseholds and options to acquire real property and leaseholds;

interests in mortgage loans secured by real property;

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stock in other REITs;

investments in stock or debt instruments during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt with at least a five-year term; and

regular or residual interests in a REMIC. However, if less than 95% of the assets of a REMIC consist of assets that are qualifying real estate-related assets under the federal income tax laws, determined as if we held such assets, we will be treated as holding directly our proportionate share of the assets of such REMIC.

Under recently enacted legislation, the term "cash" for purposes of the REIT asset qualification rules is defined to include foreign currency if the REIT or its qualified business unit uses such foreign currency as its functional currency, but only to the extent such foreign currency is held for use in the normal course of the activities of the REIT or the qualified business unit giving rise to income in the numerator for the 75% or 95% income tests, or directly related to acquiring or holding assets qualifying for the numerator in the 75% assets test, and is not held in connection with a trade or business of trading or dealing in certain securities. This change became effective with our 2009 tax year.

Second, not more than 25% of the value of our total assets may be represented by securities (other than those included in the preceding category).

Third, not more than 25% of the value of our total assets may be represented by securities of one or more taxable REIT subsidiaries.

Fourth, except with respect to a taxable REIT subsidiary and securities includible in the first category above, (a) not more than 5% of the value of our total assets may be represented by securities of any one issuer, (b) we may not hold securities possessing more than 10% of the total voting power of the outstanding securities of any one issuer and (c) we may not hold securities having a value of more than 10% of the total value of the outstanding securities of any one issuer.

For purposes of the second and third asset tests, the term "securities" does not include stock in another REIT, equity or debt securities of a qualified REIT subsidiary or taxable REIT subsidiary, mortgage loans that constitute real estate assets, or equity interests in a partnership. For purposes of the 10% value test, the term "securities" does not include:

Straight debt securities, which is defined as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the debt is not convertible, directly or indirectly, into stock, and (ii) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors. Straight debt securities do not include any securities issued by a partnership or a corporation in which we or any controlled taxable REIT subsidiary (i.e., a taxable REIT subsidiary in which we own directly or indirectly more than 50% of the voting power or value of the stock) hold non- straight debt securities that have aggregate value of more than 1% of the issuer's outstanding securities. However, straight debt securities include debt subject to the following contingencies:

a contingency relating to the time of payment of interest or principal, as long as either (i) there is no change to the effective yield of the debt obligation other than a change to the annual yield that does not exceed the greater of 0.25% or 5% of the annual yield, or (ii) neither the aggregate issue price nor the aggregate face amount of the issuer's debt obligations held by us exceeds \$1 million and no more than 12 months of unaccrued interest on the debt obligations can be required to be prepaid; and

a contingency relating to the time or amount of payment upon a default or prepayment of a debt obligation, as long as the contingency is consistent with customary commercial practice.

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Any loan to an individual or an estate.

Any section 467 rental agreement other than an agreement with a related party tenant.

Any obligation to pay rents from real property.

Certain securities issued by governmental entities.

Any security issued by a REIT.

Any debt instrument of an entity treated as a partnership for federal income tax purposes to the extent of our interest as a partner in the partnership.

Any debt instrument of an entity treated as a partnership for federal income tax purposes not described in the preceding bullet points if at least 75% of the partnership's gross income, excluding income from prohibited transaction, is qualifying income for purposes of the 75% gross income test described above in Income Tests.

The asset tests described above are based on our gross assets. For federal income tax purposes, we will be treated as owning both the loans we hold directly and the loans that we have securitized through non-REMIC debt securitizations. Although we will have a partially offsetting obligation with respect to the securities issued pursuant to the securitizations, these offsetting obligations will not reduce the gross assets we are considered to own for purposes of the asset tests.

We believe that all or substantially all of the mortgage loans and MBS that we will own will be qualifying assets for purposes of the 75% asset test. For purposes of these rules, however, if the outstanding principal balance of a mortgage loan exceeds the fair market value of the real property securing the loan, a portion of such loan likely will not be a qualifying real estate asset under the federal income tax laws. Although the law on the matter is not entirely clear, it appears that the non-qualifying portion of that mortgage loan will be equal to the portion of the loan amount that exceeds the value of the associated real property that is security for that loan. To the extent that we own debt securities issued by other REITs or C corporations that are not secured by a mortgage on real property, those debt securities will not be qualifying assets for purposes of the 75% asset test. Instead, we would be subject to the second, third and fourth asset tests with respect to those debt securities.

We will monitor the status of our assets for purposes of the various asset tests and will seek to manage our investment portfolio to comply at all times with such tests. There can be no assurance, however, that we will be successful in this effort. In this regard, to determine our compliance with these requirements, we will need to estimate the value of the real estate securing our mortgage loans at various times. Although we will seek to be prudent in making these estimates, there can be no assurances that the IRS might not disagree with these determinations and assert that a lower value is applicable. If we fail to satisfy the asset tests at the end of a calendar quarter, we will not lose our REIT status if:

we satisfied the asset tests at the end of the preceding calendar quarter; and

the discrepancy between the value of our assets and the asset test requirements arose from changes in the market values of our assets and was not wholly or partly caused by the acquisition of one or more non-qualifying assets, or solely by a change in the foreign currency exchange rate used to value a foreign asset.

If we did not satisfy the condition described in the second item, above, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

In the event that, at the end of any calendar quarter, we violate the second or third asset tests described above, we will not lose our REIT status if (i) the failure is de minimis (up to the lesser of 1% of our assets or \$10 million) and (ii) we dispose of assets or otherwise comply with the asset

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tests within six months after the last day of the quarter in which we identify such failure. In the event of a more than de minimis failure of any of the

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asset tests, as long as the failure was due to reasonable cause and not to willful neglect, we will not lose our REIT status if (i) we dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure and (ii) pay a tax equal to the greater of \$50 thousand or 35% of the net income from the non-qualifying assets during the period in which we failed to satisfy the asset tests.

We currently believe that the loans, securities and other assets that we expect to hold will satisfy the foregoing asset test requirements. However, no independent appraisals will be obtained to support our conclusions as to the value of our assets and securities, or in many cases, the real estate collateral for the mortgage loans that we hold. Moreover, the values of some assets may not be susceptible to a precise determination. As a result, there can be no assurance that the IRS will not contend that our ownership of securities and other assets violates one or more of the asset tests applicable to REITs.

Distribution Requirements

Each taxable year, we must distribute dividends, other than capital gain dividends and deemed distributions of retained capital gain, to our stockholders in an aggregate amount at least equal to:

the sum of:

90% of our REIT taxable income, computed without regard to the dividends paid deduction and our net capital gain or loss, and

90% of our after-tax net income, if any, from foreclosure property, minus

the sum of certain items of excess non-cash income.

We must pay such distributions in the taxable year to which they relate or in the following taxable year if we declare the distribution before we timely file our federal income tax return for the year and pay the distribution on or before the first regular dividend payment date after such declaration. In addition, dividends declared in October, November or December payable to stockholders of record in such month are deemed received by stockholders on December 31 and to have been paid on December 31 if actually paid in January of the following year. See below under Distributions Generally.

We will pay the federal income tax on taxable income, including net capital gain, which we do not distribute to stockholders. Furthermore, if we fail to distribute during a calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

85% of our REIT ordinary income for such year,

95% of our REIT capital gain income for such year, and

any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year. See Taxation of Taxable U.S. Stockholders. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% nondeductible excise tax described above. We intend to make timely distributions sufficient to satisfy the annual distribution requirements and to avoid corporate income tax and the 4% nondeductible excise tax.

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It is possible that, from time to time, we may experience timing differences between the actual receipt of income and actual payment of deductible expenses and the inclusion of that income and deduction of such expenses in arriving at our REIT taxable income. Possible examples of those timing differences include the following:

Because we may deduct capital losses only to the extent of our capital gains, we may have taxable income that exceeds our economic income.

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We will recognize taxable income in advance of the related cash flow if any of our mortgage loans or MBS are deemed to have original issue discount. We generally must accrue original issue discount based on a constant yield method that takes into account projected prepayments but that defers taking into account credit losses until they are actually incurred.

We may recognize taxable market discount income when we receive the proceeds from the disposition of, or principal payments on, loans that have a stated redemption price at maturity that is greater than our tax basis in those loans, although such proceeds often will be used to make non-deductible principal payments on related borrowings.

We may recognize taxable income without receiving a corresponding cash distribution if we foreclose on or make a significant modification to a loan to the extent that the fair market value of the underlying property or the principal amount of the modified loan, as applicable, exceeds our basis in the original loan.

We may recognize phantom taxable income from any residual interests in REMICs or retained ownership interests in mortgage loans subject to collateralized mortgage obligation debt.

Although several types of non-cash income are excluded in determining the annual distribution requirement, we will incur corporate income tax and the 4% nondeductible excise tax with respect to those non-cash income items if we do not distribute those items on a current basis. As a result of the foregoing, we may have less cash than is necessary to distribute all of our taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or issue additional common stock or preferred stock.

Under certain circumstances, we may be able to correct a failure to meet the distribution requirement for a year by paying deficiency dividends to our stockholders in a later year. We may include such deficiency dividends in our deduction for dividends paid for the earlier year. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

The IRS has provided temporary assistance to REITs that wish to preserve cash, but that also must meet their minimum distribution requirements. This assistance applies to distributions by REITs of the REIT's own stock declared on or after January 1, 2008 and on or before December 31, 2009. We have not declared such a distribution.

Pursuant to Revenue Procedure 2008-68, a distribution of stock by a REIT will be treated as a dividend equal to the amount of money which could have been received in the distribution if:

- (1) The distribution is made by the corporation to its shareholders with respect to its stock;
- (2) Stock of the corporation is publicly traded on an established securities market in the United States;
- (3) The distribution is declared with respect to a taxable year ending on or before December 31, 2009;
- (4) Pursuant to such declaration, each shareholder may elect to receive its entire entitlement under the declaration in either money or stock of the distributing corporation of equivalent value subject to a limitation on the amount of money to be distributed in the aggregate to all shareholders (the "Cash Limitation"), provided that:
 - (a) such Cash Limitation is not less than 10% of the aggregate declared distribution, and
 - (b) if too many shareholders elect to receive money, each shareholder electing to receive money will receive a pro rata amount of money corresponding to their respective entitlement under the declaration, but in no event will any shareholder electing to receive money receive less than 10% of their entire entitlement under the declaration in money;

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(5) The calculation of the number of shares to be received by any shareholder will be determined, as close as practicable to the payment date, based upon a formula utilizing market prices that is designed to equate in value the number of shares to be received with the amount of money that could be received instead. For purposes of applying (4) above, the value of the shares to be distributed shall be determined by using the formula described in the preceding sentence; and

(6) With respect to any shareholder participating in a dividend reinvestment plan (DRIP), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in money under (4) above. We have not made any such taxable stock distributions.

Recordkeeping Requirements

We must maintain certain records in order to qualify as a REIT. In addition, to avoid a monetary penalty, we must request, on an annual basis, information from our stockholders designed to disclose the actual ownership of our outstanding stock. We intend to comply with these requirements.

Failure to Qualify

If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and the asset tests, we could avoid disqualification if our failure is due to reasonable cause and not to willful neglect and we pay a penalty of \$50 thousand for each such failure. In addition, there are relief provisions for a failure of the gross income tests and asset tests as described in [Income Tests](#) and [Asset Tests](#).

If we fail to qualify as a REIT in any taxable year and no relief provision applies, we would be subject to federal income tax and any applicable alternative minimum tax on our taxable income at regular corporate rates. In calculating our taxable income in a year in which we fail to qualify as a REIT, we would not be able to deduct amounts paid out to stockholders. In fact, we would not be required to distribute any amounts to stockholders in that year. In such event, to the extent of our current and accumulated earnings and profits, all distributions to stockholders would be taxable as ordinary income. Subject to certain limitations of the federal income tax laws, corporate stockholders might be eligible for the dividends received deduction and domestic non-corporate stockholders may be eligible for the reduced federal income tax rate of 15% on qualified dividends. Unless we qualified for relief under specific statutory provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT. We cannot predict whether, in all circumstances, we would qualify for such statutory relief.

Qualified REIT Subsidiaries

A qualified REIT subsidiary is any corporation in which we own 100% of such corporation's outstanding stock and for which no election has been made to classify it as a taxable REIT subsidiary. As such, their assets, liabilities and income would generally be treated as our assets, liabilities and income for purposes of each of the above REIT qualification tests. We currently have no qualified REIT subsidiaries.

Taxable REIT Subsidiaries

A taxable REIT subsidiary is any corporation in which we own stock (directly or indirectly) and which we and such corporation elect to classify as a taxable REIT subsidiary. A taxable REIT subsidiary is not subject to the REIT asset, income and distribution requirements, nor are its assets, liabilities or income treated as our assets, liabilities or income for purposes of each of the above REIT qualification tests. We currently have no taxable REIT subsidiaries. We generally intend to make a taxable REIT subsidiary election with respect to any other corporation in which we acquire securities constituting more than 10% by vote or value of such corporation and that is not a qualified REIT subsidiary. However, the aggregate value of all of our taxable REIT subsidiaries must be limited to 25% of the total value of our assets.

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We will be subject to a 100% penalty tax on any rent, interest or other charges that we impose on any taxable REIT subsidiary in excess of an arm's length price for comparable services. We expect that any rents, interest or other charges imposed on any taxable REIT subsidiary will be at arm's length prices.

We generally expect to derive income from our taxable REIT subsidiaries by way of dividends in the event that we establish any taxable REIT subsidiaries. Such dividends are not real estate source income for purposes of the 75% income test, although they are included for purposes of the 95% test. Therefore, when aggregated with our non-real estate source income, such dividends must be limited to 25% of our gross income each year. We will monitor the value of our investment in, and the distributions from, our taxable REIT subsidiaries to ensure compliance with all applicable REIT income and asset tests in the event that we establish any taxable REIT subsidiaries.

Taxable REIT subsidiaries are generally subject to corporate level tax on their net income and will generally be able to distribute only net after-tax earnings to its stockholders, including us, as dividend distributions. Our dividends sourced from dividends received from taxable REIT subsidiaries (if any) can qualify for the 15% tax rate on qualified dividends.

Taxation of Taxable U.S. Stockholders

For purposes of the discussion in this Annual Report on Form 10-K, the term "U.S. stockholder" means a holder of our stock that is, for U.S. federal income tax purposes:

a citizen or resident of the U.S.;

a corporation (including an entity treated as a corporation for federal income tax purposes), partnership or other entity created or organized in or under the laws of the U.S. or of any state thereof or in the District of Columbia, unless Treasury regulations provide otherwise;

an estate the income of which is subject to U.S. federal income taxation regardless of its source; or

a trust (i) whose administration is subject to the primary supervision of a U.S. court and which has one or more U.S. persons who have the authority to control all substantial decisions of the trust or (ii) that has a valid election in place to be treated as a U.S. person.

Distributions Generally

Distributions out of our current or accumulated earnings and profits, other than capital gain dividends, will generally be taxable to U.S. stockholders as ordinary income. Provided that we continue to qualify as a REIT, dividends paid by us will not be eligible for the dividends received deduction generally available to U.S. stockholders that are corporations. To the extent that we make distributions in excess of current and accumulated earnings and profits, the distributions will be treated as a tax-free return of capital to each U.S. stockholder and will reduce the adjusted tax basis which each U.S. stockholder has in our stock by the amount of the distribution, but not below zero. Distributions in excess of a U.S. stockholder's adjusted tax basis in its stock will be taxable as capital gain and will be taxable as long-term capital gain if the stock has been held for more than one year. If we declare a dividend in October, November, or December of any calendar year which is payable to stockholders of record on a specified date in such a month and actually pay the dividend during January of the following calendar year, the dividend is deemed to be paid by us and received by the stockholder on December 31st of the previous year, but only to the extent we have any remaining undistributed earnings and profits (as computed under the Code) as of December 31st. Any portion of this distribution in excess of our previously undistributed earnings and profits as of December 31st should be treated as a distribution to our stockholders in the following calendar year for U.S. federal income tax purposes. Stockholders may not include in their own income tax returns any of our net operating losses or capital losses. Ordinary dividends to a U.S. stockholder generally will not qualify for the 15% tax rate for qualified dividend income. However, the 15% tax rate for qualified dividend income will apply to our ordinary REIT dividends (i) attributable to dividends received by us from non-REIT corporations such as a taxable REIT subsidiary, and (ii) any income on which we have paid a corporate income tax.

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Capital Gain Distributions

Distributions designated by us as capital gain dividends will be taxable to U.S. stockholders as capital gain income. We can designate distributions as capital gain dividends to the extent of our net capital gain for the taxable year of the distribution. This capital gain income will generally be taxable to non-corporate U.S. stockholders at a 15% or 25% rate based on the characteristics of the asset we sold that produced the gain. U.S. stockholders that are corporations may be required to treat up to 20% of certain capital gain dividends as ordinary income.

Retention of Net Capital Gains

We may elect to retain, rather than distribute as a capital gain dividend, our net capital gains. If we were to make this election, we would pay tax on such retained capital gains. In such a case, our stockholders would generally:

include their proportionate share of our undistributed net capital gains in their taxable income;

receive a credit for their proportionate share of the tax paid by us in respect of such net capital gain; and

increase the adjusted basis of their stock by the difference between the amount of their share of our undistributed net capital gain and their share of the tax paid by us.

Passive Activity Losses, Investment Interest Limitations and Other Considerations of Holding Our Stock

Distributions we make and gains arising from the sale or exchange of our stock by a U.S. stockholder will not be treated as passive activity income. As a result, U.S. stockholders will not be able to apply any passive losses against income or gains relating to our stock. Distributions by us, to the extent they do not constitute a return of capital, generally will be treated as investment income for purposes of computing the investment interest limitation under the Code. Further, if we, or a portion of our assets, were to be treated as a taxable mortgage pool, any excess inclusion income that is allocated to you could not be offset by any losses or other deductions you may have.

Dispositions of Stock

A U.S. stockholder that sells or disposes of our stock will recognize gain or loss for federal income tax purposes in an amount equal to the difference between the amount of cash or the fair market value of any property the stockholder receives on the sale or other disposition and the stockholder's adjusted tax basis in the stock. This gain or loss will be capital gain or loss and will be long-term capital gain or loss if the stockholder has held the stock for more than one year. In general, any loss recognized by a U.S. stockholder upon the sale or other disposition of our stock that the stockholder has held for six months or less will be treated as long-term capital loss to the extent the stockholder received distributions from us which were required to be treated as long-term capital gains. All or a portion of any loss that a U.S. stockholder realizes upon a taxable disposition of our common stock may be disallowed if the stockholder purchases other stock within 30 days before or after the disposition.

Information Reporting and Backup Withholding

We report to our U.S. stockholders and the IRS the amount of dividends paid during each calendar year and the amount of any tax withheld. Under the backup withholding rules, a stockholder may be subject to backup withholding with respect to dividends paid and redemption proceeds unless the holder is a corporation or comes within other exempt categories and, when required, demonstrates this fact or provides a taxpayer identification number or social security number certifying as to no loss of exemption from backup withholding and otherwise complies with applicable requirements of the backup withholding rules. A U.S. stockholder that does not provide

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us with its correct taxpayer identification number or social security number may also be subject to penalties imposed by the IRS. A U.S. stockholder can meet this requirement by providing us with a correct, properly completed and executed copy of IRS Form W-9 or a substantially similar form. Backup withholding is not an additional tax. Any amount paid as backup withholding will be creditable against the stockholder's income tax liability, if any, and otherwise be refundable. In addition, we may be required to withhold a portion of capital gain distributions made to any stockholders who fail to certify their non-foreign status.

Taxation of Tax-Exempt Stockholders

The IRS has ruled that amounts distributed as a dividend by a REIT will be treated as a dividend by the recipient and excluded from the calculation of unrelated business taxable income, or UBTI, when received by a tax-exempt entity. Based on that ruling, provided that a tax-exempt stockholder has not held our stock as debt financed property within the meaning of the Code, i.e., property, the acquisition, or holding of which is financed through a borrowing by the tax-exempt U.S. stockholder, the stock is not otherwise used in an unrelated trade or business, and we do not hold a residual interest in a REMIC that gives rise to excess inclusion income, as defined in Section 860E of the Code, dividend income on our stock and income from the sale of our stock should not be unrelated business taxable income to a tax-exempt stockholder. However, if we or a pool of our assets were to be treated as a taxable mortgage pool, a portion of the dividends paid to a tax-exempt stockholder may be subject to tax as unrelated business taxable income. Although we do not believe that we, or any portion of our assets, will be treated as a taxable mortgage pool, no assurance can be given that the IRS might not successfully maintain that such a taxable mortgage pool exists.

For tax-exempt stockholders that are social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans exempt from federal income taxation under Sections 501(c)(7), (c)(9), (c)(17) and (c)(20) of the Code, respectively, income from an investment in our stock will constitute unrelated business taxable income unless the organization is able to properly claim a deduction for amounts set aside or placed in reserve for certain purposes so as to offset the income generated by its investment in our stock. Any prospective and current investors should consult their tax advisors concerning these set aside and reserve requirements.

Notwithstanding the above, however, a substantial portion of the dividends a tax-exempt stockholder receives may constitute UBTI if we are treated as a pension-held REIT and the stockholder is a pension trust which:

is described in Section 401(a) of the Code; and

holds more than 10%, by value, of the interests in the REIT.

Tax-exempt pension funds that are described in Section 401(a) of the Code and exempt from tax under Section 501(a) of the Code are referred to below as qualified trusts.

A REIT is a pension-held REIT if:

it would not have qualified as a REIT but for the fact that Section 856(h)(3) of the Code provides that stock owned by a qualified trust shall be treated, for purposes of the 5/50 Rule, described above, as owned by the beneficiaries of the trust, rather than by the trust itself; and

either at least one qualified trust holds more than 25%, by value, of the interests in the REIT, or one or more qualified trusts, each of which owns more than 10%, by value, of the interests in the REIT, holds in the aggregate more than 50%, by value, of the interests in the REIT.

The percentage of any REIT dividend treated as unrelated business taxable income is equal to the ratio of:

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the unrelated business taxable income earned by the REIT, less directly related expenses, treating the REIT as if it were a qualified trust and therefore subject to tax on unrelated business taxable income, to

the total gross income, less directly related expenses, of the REIT.

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A de minimis exception applies where the percentage is less than 5% for any year. As a result of the limitations on the transfer and ownership of stock contained in our charter, we do not expect to be classified as a pension-held REIT.

Taxation of Non-U.S. Stockholders

The rules governing federal income taxation of non-U.S. stockholders are complex and no attempt will be made herein to provide more than a summary of these rules. Non-U.S. stockholders means beneficial owners of shares of our stock that are not U.S. stockholders (as such term is defined in the discussion above under the heading entitled "Taxation of Taxable U.S. Stockholders").

PROSPECTIVE AND CURRENT NON-U.S. STOCKHOLDERS SHOULD CONSULT THEIR TAX ADVISORS TO DETERMINE THE IMPACT OF FOREIGN, FEDERAL, STATE AND LOCAL INCOME TAX LAWS WITH REGARD TO AN INVESTMENT IN OUR STOCK AND OF OUR ELECTION TO BE TAXED AS A REAL ESTATE INVESTMENT TRUST, INCLUDING ANY REPORTING REQUIREMENTS.

Distributions to non-U.S. stockholders that are not attributable to gain from our sale or exchange of U.S. real property interests, and that are not designated by us as capital gain dividends or retained capital gains, will be treated as dividends of ordinary income to the extent that they are made out of our current or accumulated earnings and profits. These distributions will generally be subject to a withholding tax equal to 30% of the distribution unless an applicable tax treaty reduces or eliminates that tax. However, if income from an investment in our stock is treated as effectively connected with the non-U.S. stockholder's conduct of a U.S. trade or business, the non-U.S. stockholder generally will be subject to federal income tax at graduated rates on a net basis in the same manner as U.S. stockholders are taxed with respect to those distributions and also may be subject to the 30% branch profits tax in the case of a non-U.S. stockholder that is a corporation. We expect to withhold tax at the rate of 30% on the gross amount of any distributions made to a non-U.S. stockholder unless:

a lower treaty rate applies and any required form, for example IRS Form W-8BEN, evidencing eligibility for that reduced rate is filed by the non-U.S. stockholder with us; or

the non-U.S. stockholder files an IRS Form W-8ECI with us claiming that the distribution is effectively connected income. Any portion of the dividends paid to non-U.S. stockholders that is treated as excess inclusion income will not be eligible for exemption from the 30% withholding tax or a reduced treaty rate.

Distributions in excess of our current and accumulated earnings and profits will not be taxable to non-U.S. stockholders to the extent that these distributions do not exceed the adjusted basis of the stockholder's stock, but rather will reduce the adjusted basis of that stock. To the extent that distributions in excess of current and accumulated earnings and profits exceed the adjusted basis of a non-U.S. stockholder's stock, these distributions will give rise to tax liability if the non-U.S. stockholder would otherwise be subject to tax on any gain from the sale or disposition of its stock, as described below. Because it generally cannot be determined at the time a distribution is made whether or not such distribution may be in excess of current and accumulated earnings and profits, the entire amount of any distribution normally will be subject to withholding at the same rate as a dividend. However, amounts so withheld are creditable against U.S. tax liability, if any, or refundable by the IRS to the extent the distribution is subsequently determined to be in excess of our current and accumulated earnings and profits. We are also required to withhold 10% of any distribution in excess of our current and accumulated earnings and profits if our stock is a U.S. real property interest and if we are not a domestically controlled REIT, as discussed below. Consequently, although we intend to withhold at a rate of 30% on the entire amount of any distribution, to the extent that we do not do so, any portion of a distribution not subject to withholding at a rate of 30% may be subject to withholding at a rate of 10%.

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Distributions attributable to our capital gains which are not attributable to gain from the sale or exchange of a U.S. real property interest generally will not be subject to income taxation unless (1) investment in our stock is effectively connected with the non-U.S. stockholder's U.S. trade or business (or, if an income tax treaty applies, is attributable to a U.S. permanent establishment of the non-U.S. stockholder), in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to such gain (except that a corporate non-U.S. stockholder may also be subject to the 30% branch profits tax), or (2) the non-U.S. stockholder is a non-resident alien individual who is present in the U.S. for 183 days or more during the taxable year and certain other conditions are satisfied, in which case the non-resident alien individual will be subject to a 30% tax on the individual's capital gains.

For any year in which we qualify as a REIT, distributions that are attributable to gain from the sale or exchange of a U.S. real property interest, which includes some interests in real property, but generally does not include an interest solely as a creditor in mortgage loans or MBS, will be taxed to a non-U.S. stockholder under the provisions of the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA. Under FIRPTA, distributions attributable to gain from sales of U.S. real property interests are taxed to a non-U.S. stockholder as if that gain were effectively connected with the stockholder's conduct of a U.S. trade or business. Non-U.S. stockholders thus would be taxed at the normal capital gain rates applicable to stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals. Distributions subject to FIRPTA also may be subject to the 30% branch profits tax in the hands of a non-U.S. corporate stockholder. We are required to withhold 35% of any distribution that we designate (or, if greater, the amount that we could designate) as a capital gains dividend. The amount withheld is creditable against the non-U.S. stockholder's FIRPTA tax liability.

A capital gain distribution from a REIT to a foreign investor has been removed from the category of effectively connected income, provided that (i) the distribution is received with respect to a class of stock that is regularly traded on an established securities market located in the U.S. (our stock currently is so traded) and (ii) the foreign investor does not own more than 5% of the class of stock at any time during the taxable year within which the distribution is received. In that case, the foreign investor is not required to file a U.S. federal income tax return by reason of receiving such a distribution. The distribution is to be treated as a REIT dividend to that investor, taxed as a REIT dividend that is not a capital gain. Also, the branch profits tax does not apply to such a distribution.

Gains recognized by a non-U.S. stockholder upon a sale of our stock generally will not be taxed under FIRPTA if we are a domestically-controlled REIT, which is a REIT in which at all times during a specified testing period less than 50% in value of the stock was held directly or indirectly by non-U.S. stockholders. Because our stock is publicly traded, we cannot assure our investors that we are or will remain a domestically-controlled REIT. Even if we are not a domestically-controlled REIT, however, a non-U.S. stockholder that owns, actually or constructively, 5% or less of our stock throughout a specified testing period will not recognize taxable gain on the sale of our stock under FIRPTA if the shares are traded on an established securities market.

If gain from the sale of the stock were subject to taxation under FIRPTA, the non-U.S. stockholder would be subject to the same treatment as U.S. stockholders with respect to that gain, subject to applicable alternative minimum tax, a special alternative minimum tax in the case of nonresident alien individuals, and the possible application of the 30% branch profits tax in the case of non-U.S. corporations. In addition, the purchaser of the stock could be required to withhold 10% of the purchase price and remit such amount to the IRS.

Gains not subject to FIRPTA will be taxable to a non-U.S. stockholder if:

the non-U.S. stockholder's investment in the stock is effectively connected with a trade or business in the U.S., in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to that gain; or

the non-U.S. stockholder is a nonresident alien individual who was present in the U.S. for 183 days or more during the taxable year and other conditions are met, in which case the nonresident alien individual will be subject to a 30% tax on the individual's capital gains.

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Information Reporting and Backup Withholding

If the proceeds of a disposition of our stock are paid by or through a U.S. office of a broker-dealer, the payment is generally subject to information reporting and to backup withholding (currently at a rate of 28%) unless the disposing non-U.S. stockholder certifies as to his name, address and non-U.S. status or otherwise establishes an exemption. Generally, U.S. information reporting and backup withholding will not apply to a payment of disposition proceeds if the payment is made outside the U.S. through a foreign office of a foreign broker-dealer. If the proceeds from a disposition of our stock are paid to or through a foreign office of a U.S. broker-dealer or a non-U.S. office of a foreign broker-dealer that is (i) a controlled foreign corporation for federal income tax purposes, (ii) a foreign person 50% or more of whose gross income from all sources for a three-year period was effectively connected with a U.S. trade or business, (iii) a foreign partnership with one or more partners who are U.S. persons and who in the aggregate hold more than 50% of the income or capital interest in the partnership, or (iv) a foreign partnership engaged in the conduct of a trade or business in the U.S., then (i) backup withholding will not apply unless the broker-dealer has actual knowledge that the owner is not a foreign stockholder, and (ii) information reporting will not apply if the non-U.S. stockholder satisfies certification requirements regarding its status as a foreign stockholder.

State, Local and Foreign Taxation

We may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which we transact business or make investments, and our stockholders may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which they reside. Our state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. In addition, a stockholder's state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. Consequently, prospective investors should consult their tax advisors regarding the effect of state, local and foreign tax laws on an investment in our stock.

Possible Legislative or Other Actions Affecting Tax Considerations

Prospective investors and stockholders should recognize that the present U.S. federal income tax treatment of an investment in our stock may be modified by legislative, judicial or administrative action at any time and that any such action may affect investments and commitments previously made. The rules dealing with U.S. federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Treasury Department, resulting in revisions of regulations and revised interpretations of established concepts as well as statutory changes. Revisions in U.S. federal tax laws and interpretations thereof could adversely affect the tax consequences of an investment in our stock.

Item 1A. RISK FACTORS

Our business routinely encounters and attempts to address risks, some of which will cause our future results to differ, sometimes materially, from those originally anticipated. Below, we have described our present view of certain important risks. The risk factors set forth below are not the only risks that we may face or that could adversely affect us. If any of the risks discussed in this Annual Report on Form 10-K actually occur, our business, financial condition and results of operations could be materially adversely affected. If this were to occur, the trading price of our securities could decline significantly and you may lose all or part of your investment.

The following discussion of risk factors contains forward-looking statements, which may be important to understanding any statement in this Annual Report on Form 10-K or in our other filings and public disclosures. In particular, the following information should be read in conjunction with Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) and Item 8 Financial Statements and Supplementary Data of this Annual Report on Form 10-K.

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Risks Related to Our Business

Continued adverse developments in the global capital markets, including recent defaults, credit losses and liquidity concerns, as well as recent mergers, acquisitions and bankruptcies of potential repurchase agreement counterparties, could make it difficult for us to borrow money to acquire Agency MBS on a leveraged basis, on favorable terms or at all, which could adversely affect our profitability.

We rely on the availability of financing to acquire Agency MBS on a leveraged basis. Institutions from which we obtain financing may have owned or financed MBS and other assets, which have declined in value and caused them to suffer losses as a result of the downturn in the residential mortgage market. As these conditions persist, institutions may be forced to exit the repurchase market, become insolvent or further tighten their lending standards or increase the amount of equity capital or haircut required to obtain financing and, in such event, could make it more difficult for us to obtain financing on favorable terms or at all.

Recently, there have been several proposed or completed mergers, acquisitions and bankruptcies of investment banks and commercial banks that have historically acted as repurchase agreement counterparties. This has resulted in a fewer number of potential repurchase agreement counterparties operating in the market. Fewer potential counterparties reduces our ability to diversify and thereby attempt to minimize risk of counterparty default. In addition, many commercial banks, investment banks and insurance companies have announced extensive losses from exposure to the residential mortgage market. These losses have reduced financial industry capital, leading to reduced liquidity for some institutions, which could also make it more difficult for us to obtain financing on favorable terms or at all. Our profitability may be adversely affected if we are unable to obtain cost-effective financing for our investments.

Failure to procure funding on favorable terms, or at all, would adversely affect our results and may, in turn, negatively affect the market price of shares of our common stock, Series A Preferred Stock or Series B Preferred Stock.

The current weakness in the mortgage market could cause one or more of our lenders to be unwilling or unable to provide us with financing. This could potentially increase our financing costs and reduce liquidity. Furthermore, if many of our lenders are unwilling or unable to provide us with additional financing, we could be forced to sell our assets at an inopportune time when prices are depressed. If one or more major market participants fails, it could negatively impact the marketability of all fixed income securities, including Agency MBS, and this could negatively impact the value of the securities in our portfolio, thus reducing our net book value.

If we are unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of our lenders, our financial condition and earnings could be negatively impacted.

The terms and conditions of each repurchase arrangement with our lenders are negotiated on a transaction-by-transaction basis. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. We cannot assure you that we will be able to continue to negotiate favorable terms and conditions on our future repurchase arrangements.

Also, during periods of market illiquidity or due to perceived credit quality deterioration of the collateral pledged, a lender may require that less favorable asset pricing procedures be employed or the margin requirements be increased. Possible market developments, including a sharp rise in interest rates, a change in prepayment rates or increasing market concern about the value or liquidity of Agency MBS, may reduce the market value of our portfolio, which may cause our lenders to require additional collateral. Under these conditions, we may determine it is prudent to sell assets to improve our ability to pledge sufficient collateral to support our remaining borrowings. Such sales may be at disadvantageous times, which may harm our operating results and net profitability.

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Continued adverse developments in the residential mortgage market may adversely affect the value of the Agency MBS in which we intend to invest.

During the past two years, the residential mortgage market in the U.S. has experienced a variety of difficulties and changing economic conditions including recent defaults, credit losses and liquidity concerns. News of actual and potential security liquidations has increased the volatility of many financial assets including Agency MBS. As a result, values for MBS assets, including some Agency MBS, have been negatively impacted. Further increased volatility and deterioration in the broader residential mortgage and MBS markets may adversely affect the performance and market value of the Agency MBS in which we invest.

Our investments serve as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. If market conditions result in a decline in the value of our Agency MBS, our financial position and results of operations could be adversely affected.

New laws may be passed affecting the relationship between Fannie Mae and Freddie Mac, on the one hand, and the federal government, on the other, which could adversely affect the price of Agency MBS.

The interest and principal payments we expect to receive on the Agency MBS in which we invest will be guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. Unlike the Ginnie Mae certificates in which we invest, the principal and interest on securities issued by Fannie Mae and Freddie Mac are not guaranteed by the U.S. government. All the Agency MBS in which we invest depend on a steady stream of payments on the mortgages underlying the securities. Since September 2008, there have been increased market concerns about Fannie Mae's and Freddie Mac's ability to withstand future credit losses associated with securities held in their investment portfolios, and on which they provide guarantees, without the direct support of the federal government.

Fannie Mae and Freddie Mac were placed into the conservatorship of the Federal Housing Finance Agency, or FHFA, their federal regulator, pursuant to its powers under The Federal Housing Finance Regulatory Reform Act of 2008, a part of the Housing and Economic Recovery Act of 2008. As the conservator of Fannie Mae and Freddie Mac, the FHFA controls and directs the operations of Fannie Mae and Freddie Mac and may (1) take over the assets of and operate Fannie Mae and Freddie Mac with all the powers of the shareholders, the directors, and the officers of Fannie Mae and Freddie Mac and conduct all business of Fannie Mae and Freddie Mac; (2) collect all obligations and money due to Fannie Mae and Freddie Mac; (3) perform all functions of Fannie Mae and Freddie Mac which are consistent with the conservator's appointment; (4) preserve and conserve the assets and property of Fannie Mae and Freddie Mac; and (5) contract for assistance in fulfilling any function, activity, action or duty of the conservator.

In addition to FHFA becoming the conservator of Fannie Mae and Freddie Mac, the U.S. Department of the Treasury has taken various actions intended to provide Fannie Mae and Freddie Mac with additional liquidity and ensure their financial stability, including a temporary program to purchase MBS issued by Fannie Mae and Freddie Mac, which program expired on December 31, 2009 with the U.S. Treasury announcing that it purchased approximately \$220 billion of securities across a range of maturities. The U.S. Treasury's agency security purchase program is subject to the discretion of the Secretary of the Treasury. The U.S. Treasury can hold its portfolio of agency securities to maturity and, based on mortgage market conditions, may make adjustments to the portfolio. This flexibility may adversely affect the pricing and availability for our target assets. It is also possible that if and when the U.S. Treasury commits to purchase agency securities in the future, it could create additional demand that would increase the pricing of agency securities that we seek to acquire.

Given the highly fluid and evolving nature of these events, it is unclear how our business will be impacted. Based upon the further activity of the U.S. government or market response to developments at Fannie Mae or Freddie Mac, our business could be adversely impacted. Although the federal government has committed capital

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to Fannie Mae and Freddie Mac, there can be no assurance that it will be adequate for their needs. If the financial support is inadequate, these companies could continue to suffer losses and could fail to honor their guarantees and other obligations.

Shortly after Fannie Mae and Freddie Mac were placed in federal conservatorship, the Secretary of the U.S. Treasury suggested that the guarantee payment structure of Fannie Mae and Freddie Mac should be re-examined. The future roles of Fannie Mae and Freddie Mac could be significantly reduced and the nature of their guarantees could be eliminated or considerably limited relative to historical measurements. The U.S. Treasury could also stop providing credit support to Fannie Mae and Freddie Mac in the future. Any changes to the nature of the guarantees provided by Fannie Mae and Freddie Mac could redefine what constitutes an agency security and could have broad adverse market implications.

The U.S. Treasury's authority to purchase agency securities and to provide financial support to Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008 expired on December 31, 2009. The problems faced by Fannie Mae and Freddie Mac resulting in their being placed into federal conservatorship have stirred debate among some federal policy makers regarding the continued role of the federal government in providing liquidity for mortgage loans. Following expiration of the current authorization, each of Fannie Mae and Freddie Mac could be dissolved and the federal government could determine to stop providing liquidity support of any kind to the mortgage market. If Fannie Mae or Freddie Mac were eliminated, or their structures were to change radically, we would not be able to acquire agency securities from these companies, which would eliminate the major component of our business model.

Our income could be negatively affected in a number of ways depending on the manner in which related events unfold. For example, the current credit support provided by the U.S. Treasury to Fannie Mae and Freddie Mac, and any additional credit support it may provide in the future, could have the effect of lowering the interest rate we expect to receive from agency securities that we seek to acquire, thereby tightening the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio. A reduction in the supply of agency securities could also negatively affect the pricing of agency securities we seek to acquire by reducing the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio.

As indicated above, recent legislation has changed the relationship between Fannie Mae and Freddie Mac and the federal government and requires Fannie Mae and Freddie Mac to reduce the amount of mortgage loans they own or for which they provide guarantees on agency securities. Future legislation could further change the relationship between Fannie Mae and Freddie Mac and the federal government, and could also nationalize or eliminate such entities entirely. Any law affecting these government-sponsored enterprises may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae or Freddie Mac. As a result, such laws could increase the risk of loss on investments in Fannie Mae and/or Freddie Mac agency securities. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially adversely affect our business, operations and financial condition.

We are subject to the risk that, despite recent actions or proposals by the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System, banks and other financial institutions may not be willing to lend and/or interest rates and the yield curve may change, which could adversely affect our financing and our operating results.

In September 2008, the U.S. government placed both Fannie Mae and Freddie Mac under its conservatorship. Shortly thereafter, Lehman Brothers Holdings Inc. filed bankruptcy, Merrill Lynch & Co., Inc. was acquired by Bank of America, the U.S. government announced it would lend approximately \$85 billion (which was subsequently increased to over \$150 billion) to American International Group and Washington Mutual was seized by federal regulators, who then sold its assets to JPMorgan Chase.

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The Emergency Economic Stabilization Act of 2008, or EESA, was enacted. The EESA provides the U.S. Secretary of the Treasury with the authority to establish a Troubled Asset Relief Program, or TARP, to purchase from financial institutions up to \$700 billion of certain assets and equity. Under the TARP, the U.S. government has invested approximately \$250 billion into hundreds of the country's banks. In November 2008, after using a significant portion of the funds available under TARP to make preferred equity investments in certain financial institutions, the Secretary of the U.S. Treasury announced that following enactment of EESA, the U.S. Treasury had continued to examine the relative benefits of purchasing illiquid mortgage-related assets and had determined that its assessment at that time was that such purchases were not the most effective way to use limited TARP funds. However, the Secretary of the U.S. Treasury indicated that it would continue to examine whether targeted forms of asset purchase can play a useful role, relative to other potential uses of TARP resources.

On November 25, 2008, the Federal Reserve announced that it would initiate a program to purchase \$100 billion in direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and \$500 billion in Agency MBS and on March 18, 2009 it was announced that the program would be expanded to purchase up to \$1.25 trillion of Agency MBS. The Federal Reserve stated that its actions are intended to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally. The purchases of direct obligations began during the first week of December 2008 and purchases of residential MBS began on January 5, 2009. In December 2009, the Federal Reserve announced that it anticipates it will conclude its Agency MBS purchase program, purchasing \$1.25 trillion of Agency MBS and about \$175 billion of agency debt, by the end of the first quarter of 2010.

There can be no assurance that any of the programs established under the EESA will have a beneficial impact on the financial markets, including current extreme levels of volatility. To the extent the market does not respond favorably to the TARP or the TARP does not function as intended, the U.S. economy may not receive the anticipated positive impact from the legislation. In addition, the U.S. government, the Board of Governors of the Federal Reserve System and other governmental and regulatory bodies have taken and are considering taking other actions to address the financial crisis, such as the Capital Purchase Program, Public-Private Investment Program, Capital Assistance Program, Asset Guarantee Program and Targeted Investment Program. We cannot predict whether or when such actions may occur or what impact, if any, such actions could have on our business, results of operations and financial condition. While such programs may provide for more availability of credit to Anworth, there are no assurances that there will be increased availability of credit. In fact, these actions could negatively affect the availability of financing, the quantity and quality of available products, changes in interest rates and the yield curve, which could potentially adversely affect our financing and operations as well as those of the entire mortgage sector in general.

Mortgage loan modification programs and future legislative action may adversely affect the value of, and the returns on, the Agency MBS in which we invest.

The U.S. government, through the Federal Housing Authority and the Federal Deposit Insurance Corporation, has commenced implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. The programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans or the rate of interest payable on the loans, or extending the payment terms of the loans. In addition, members of the U.S. Congress have indicated support for additional legislative relief for homeowners. These loan modification programs, as well as future legislative or regulatory actions that result in the modification of outstanding mortgage loans, may adversely affect the value of, and the returns on, the Agency MBS in which we invest.

We are subject to the risk that the global credit crisis, despite efforts by global governments to halt that crisis, may affect interest rates and the availability of financing in general, which could adversely affect our financing and our operating results.

During the past two years, several large European banks, including Fortis (the largest Belgian financial services firm), Dexia S.A. (the world's largest lender to local governments) and three of the United Kingdom's

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largest banks (Royal Bank of Scotland Group Plc, HBOS Plc and Lloyds TSB Group Plc) all experienced financial difficulty and were either rescued by government assistance or by other large European banks. Several European governments coordinated plans to attempt to shore up their financial sectors through loans, credit guarantees, capital infusions, promises of continued liquidity funding and interest rate cuts. Additionally, other governments of the world's largest economic countries also implemented interest rate cuts. There is no assurance that these and other plans and programs will be successful in halting the global credit crisis or in preventing other banks from failing. If unsuccessful, this could adversely affect our financing and operations as well as those of the entire mortgage sector in general.

Our leveraging strategy increases the risks of our operations.

Relative to our investment grade Agency MBS, we generally borrow, on a short-term basis, between seven to twelve times the amount of our equity, although our borrowings may at times be above or below this amount. We incur this leverage by borrowing against a substantial portion of the market value of our mortgage-related assets. Use of leverage can enhance our investment returns (and at times when we reduce our leverage, our profitability may be reduced as a result). Leverage, however, also increases risks. In the following ways, the use of leverage increases our risk of loss and may reduce our net income by increasing the risks associated with other risk factors including a decline in the market value of our MBS or a default of a mortgage-related asset:

The use of leverage increases our risk of loss resulting from various factors including rising interest rates, increased interest rate volatility, downturns in the economy and reductions in the availability of financing or deterioration in the conditions of any of our mortgage-related assets.

A majority of our borrowings are secured by our Agency MBS, generally under repurchase agreements. A decline in the market value of the Agency MBS used to secure these debt obligations could limit our ability to borrow or result in lenders requiring us to pledge additional collateral to secure our borrowings. In that situation, we could be required to sell Agency MBS under adverse market conditions in order to obtain the additional collateral required by the lender. If these sales are made at prices lower than the carrying value of the Agency MBS, we would experience losses.

A default of a mortgage-related asset that constitutes collateral for a repurchase agreement could also result in an involuntary liquidation of the mortgage-related asset. This would result in a loss to us of the difference between the value of the mortgage-related asset upon liquidation and the amount borrowed against the mortgage-related asset.

To the extent we are compelled to liquidate qualified REIT assets to repay debts, our compliance with the REIT rules regarding our assets and our sources of income could be affected, which could jeopardize our status as a REIT. Losing our REIT status would cause us to lose tax advantages applicable to REITs and may decrease our overall profitability and distributions to our stockholders.

We may incur increased borrowing costs related to repurchase agreements and that would adversely affect our profitability.

Currently, all of our borrowings are collateralized borrowings in the form of repurchase agreements. If the interest rates on these agreements increase, that would harm our profitability.

Our borrowing costs under repurchase agreements generally correspond to short-term interest rates such as LIBOR or a short-term Treasury index, plus or minus a margin. The margins on these borrowings over or under short-term interest rates may vary depending upon:

the movement of interest rates;

the availability of financing in the market; and

the value and liquidity of our mortgage-related assets.

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An increase in interest rates may harm our book value, which could adversely affect the cash available for distribution to you and could cause the price of our securities to decline.

Increases in interest rates may harm the market value of our mortgage-related assets. Our hybrid adjustable-rate mortgage-related assets (during the fixed-rate component of the mortgages underlying such assets) and our fixed-rate securities are generally more harmed by these increases. In accordance with GAAP, we reduce our book value by the amount of any decrease in the market value of our mortgage-related assets. Losses on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from Accumulated other comprehensive income to current operations.

An increase in interest rates may cause a decrease in the volume of newly issued, or investor demand for, MBS and other mortgage-related assets, which could adversely affect our ability to acquire MBS and other mortgage-related assets that satisfy our investment objectives and to generate income and pay dividends.

Rising interest rates generally reduce the demand for consumer credit, including mortgage loans, due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of MBS and other mortgage-related assets available to us, which could affect our ability to acquire MBS and other mortgage-related assets that satisfy our investment objectives. Rising interest rates may also cause MBS and other mortgage-related assets that were issued prior to an interest rate increase to provide yields that exceed prevailing market interest rates. If rising interest rates cause us to be unable to acquire a sufficient volume of MBS or mortgage-related assets or MBS or mortgage-related assets with a yield that exceeds the borrowing cost we will incur to purchase MBS or mortgage-related assets, our ability to satisfy our investment objectives and to generate income and pay dividends in the amount expected, or at all, may be materially and adversely affected.

A flat or inverted yield curve may negatively affect our operations, book value and profitability due to its potential impact on investment yields and the supply of adjustable-rate mortgage, or ARM, products.

A flat yield curve occurs when there is little difference between short-term and long-term interest rates. An inverted yield curve occurs when short-term interest rates are higher than long-term interest rates. A flat or inverted yield curve may be an adverse environment for ARM product volume, as there may be little incentive for borrowers to choose an ARM product over a longer-term fixed-rate loan. If the supply of ARM product decreases, yields may decline due to market forces.

Our borrowing costs under repurchase agreements generally correspond to short-term interest rates such as LIBOR. A flat or inverted yield curve will likely result in lower profits.

Additionally, a flat or inverted yield curve may negatively impact the pricing of our securities. According to GAAP, if the values of our securities decrease, we reduce our book value by the amount of any decrease in the market value of our mortgage-related assets.

We depend on short-term borrowings to purchase mortgage-related assets and reach our desired amount of leverage. If we fail to obtain or renew sufficient funding on favorable terms, we will be limited in our ability to acquire mortgage-related assets and our earnings and profitability would decline.

We depend on short-term borrowings to fund acquisitions of mortgage-related assets and reach our desired amount of leverage. Accordingly, our ability to achieve our investment and leverage objectives depends on our ability to borrow money in sufficient amounts and on favorable terms. In addition, we must be able to renew or replace our maturing short-term borrowings on a continuous basis. Moreover, we depend on a limited number of lenders to provide the primary credit facilities for our purchases of mortgage-related assets.

If we cannot renew or replace maturing borrowings, we may have to sell our mortgage-related assets under adverse market conditions and may incur permanent capital losses as a result. Any number of these factors in combination may cause difficulties for us, including a possible liquidation of a major portion of our portfolio at disadvantageous prices with consequent losses, which may render us insolvent.

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Any repurchase agreements that we use to finance our assets may require us to provide additional collateral or pay down debt, and if these requirements are not met, our financial condition and prospects could deteriorate rapidly.

Our repurchase agreements involve the risk that the market value of the securities pledged or sold by us to the repurchase agreement counterparty may decline in value, in which case the counterparty may require us to provide additional collateral or to repay all or a portion of the funds advanced. We may not have additional collateral or the funds available to repay our debt at that time, which would likely result in defaults unless we are able to raise the funds from alternative sources, which we may not be able to achieve on favorable terms or at all. Posting additional collateral would reduce our liquidity and limit our ability to leverage our assets. If we cannot meet these requirements, the counterparty could accelerate its indebtedness, increase the interest rate on advanced funds and terminate our ability to borrow funds from them, which could materially and adversely affect our financial condition and ability to implement our investment strategy. In addition, in the event that the counterparty files for bankruptcy or becomes insolvent, our securities may become subject to bankruptcy or insolvency proceedings, thus depriving us of the benefit of these assets. In the event that we are unable to meet these collateral obligations, our financial condition and prospects could deteriorate rapidly.

Our use of repurchase agreements to borrow funds may give our lenders greater rights in the event that either we or a lender files for bankruptcy.

Our borrowings under repurchase agreements may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay in the event that we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that a lender files for bankruptcy. Thus, the use of repurchase agreements exposes our pledged assets to risk in the event of a bankruptcy filing by either a lender or us.

Because assets we acquire may experience periods of illiquidity, we may lose profits or be prevented from earning gains if we cannot sell mortgage-related assets at an opportune time.

We bear the risk of being unable to dispose of our mortgage-related assets at advantageous times or in a timely manner because mortgage-related assets generally experience periods of illiquidity. The lack of liquidity may result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale. As a result, the illiquidity of mortgage-related assets may cause us to lose profits and the ability to earn gains.

A decrease or lack of liquidity in our investments may adversely affect our business, including our ability to value and sell our assets.

We invest in certain MBS or other investment securities that are not publicly traded in liquid markets. Moreover, turbulent market conditions, such as those currently in effect, could significantly and negatively impact the liquidity of our assets. In some cases, it may be difficult to obtain third-party pricing on certain of our investment securities. Illiquid investments typically experience greater price volatility, as a ready market does not exist, and can be more difficult to value. In addition, third-party pricing for illiquid investments may be more subjective than for more liquid investments. The illiquidity of certain investment securities may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded certain of our investment securities. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be relatively limited, which could adversely affect our results of operations and financial condition.

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We may not have the benefit of repurchase rights or indemnification upon the breach of broad representations and warranties for all of the assets we acquire, which could increase the risk that we suffer losses on such assets.

We may acquire assets from counterparties that are not able or willing to provide broad representations and warranties on such assets. Even if such counterparties provide representations and warranties on the assets, they may not be contractually required to repurchase the assets or indemnify us if there are defaults with respect to the representations and warranties on the assets. To the extent that our counterparties are not contractually obligated to repurchase the assets or are unable to fulfill their indemnification obligations, we will bear the same risks with respect to such assets as if such representations and warranties were not made. If we do not have the benefit of repurchase rights or indemnification upon the breach of broad representations and warranties on our assets, we may lose money on our investments in such assets that we otherwise would not lose had such repurchase rights or indemnification been available.

Our hedging strategies may not be successful in mitigating our risks associated with interest rates.

We engage in hedging activity from time to time. As such, we use various derivative financial instruments to provide a level of protection against interest rate risks, but no hedging strategy can protect us completely. When interest rates change, we expect to record a gain or loss on derivatives, which would be offset by an inverse change in the value of loans or residual interests. Additionally, from time to time, we may enter into hedging transactions in connection with our holdings of MBS and government securities with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps and floors, options to purchase these items and futures and forward contracts. Our actual hedging decisions will be determined in light of the facts and circumstances existing at the time and may differ from our currently anticipated hedging strategy. We cannot assure you that our use of derivatives will offset the risks related to changes in interest rates. It is likely that there will be periods in the future during which we will incur losses after accounting for our derivative financial instruments. The derivative financial instruments we select may not have the effect of reducing our interest rate risk. In addition, the nature and timing of hedging transactions may influence the effectiveness of these strategies. Poorly designed strategies or improperly executed transactions could actually increase our risk and losses. In addition, hedging strategies involve transaction and other costs. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses.

The characteristics of hedging instruments presents various concerns, including illiquidity, enforceability and counterparty risks, which could adversely affect our business and results of operations.

Hedging involves risk since hedging instruments often are not traded on regulated exchanges, guaranteed by an exchange or its clearing house, or regulated by any U.S. or foreign governmental authorities. Consequently, there are no requirements with respect to record keeping, financial responsibility or segregation of customer funds and positions. Furthermore, the enforceability of such instruments may depend on compliance with applicable statutory and commodity and other regulatory requirements and, depending on the identity of the counterparty, applicable international requirements. The business failure of a hedging counterparty with whom we enter into a hedging transaction will most likely result in its default. Default by a party with whom we enter into a hedging transaction may result in a loss and force us to cover our commitments, if any, at the then current market price. Although generally we will seek to reserve the right to terminate our hedging positions, it may not always be possible to dispose of or close out a hedging position without the consent of the hedging counterparty and we may not be able to enter into an offsetting contract in order to cover our risk. We cannot assure you that a liquid secondary market will exist for hedging instruments purchased or sold, and we may be required to maintain a position until exercise or expiration, which could result in losses.

Our use of derivatives may expose us to counterparty risks.

From time to time we enter into interest rate swap and cap agreements to hedge risks associated with movements in interest rates. If a swap counterparty cannot perform under the terms of an interest rate swap, we

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would not receive payments due under that agreement, we may lose any unrealized gain associated with the interest rate swap, and the hedged liability would cease to be hedged by the interest rate swap. We may also be at risk for any collateral we have pledged to secure our obligations under the interest rate swap if the counterparty becomes insolvent or files for bankruptcy. Similarly, if a cap counterparty fails to perform under the terms of the cap agreement, in addition to not receiving payments due under that agreement that would off-set our interest expense, we would also incur a loss for all remaining unamortized premium paid for that agreement.

Competition may prevent us from acquiring mortgage-related assets at favorable yields and that would negatively impact our profitability.

Our net income largely depends on our ability to acquire mortgage-related assets at favorable spreads over our borrowing costs. In acquiring mortgage-related assets, we compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, mutual funds, other lenders and other entities that purchase mortgage-related assets, many of which have greater financial resources than us. As a result, we may not in the future be able to acquire sufficient mortgage-related assets at favorable spreads over our borrowing costs. If that occurs, our profitability will be harmed.

Interest rate mismatches between our adjustable-rate MBS and our borrowings used to fund our purchases of these assets may reduce our income during periods of changing interest rates.

We fund most of our acquisitions of adjustable-rate MBS with borrowings that have interest rates based on indices and repricing terms similar to, but of shorter maturities than, the interest rate indices and repricing terms of our MBS. Accordingly, if short-term interest rates increase, this may harm our profitability.

Most of the MBS we acquire are adjustable-rate securities. This means that their interest rates may vary over time based upon changes in a short-term interest rate index. Therefore, in most cases, the interest rate indices and repricing terms of the MBS that we acquire and their funding sources will not be identical, thereby creating an interest rate mismatch between our assets and liabilities. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods when the spread between these indices was volatile. During periods of changing interest rates, these mismatches could reduce our net income, dividend yield and the market price of our stock.

The interest rates on our borrowings generally adjust more frequently than the interest rates on our adjustable-rate MBS. For example, at December 31, 2009, our Agency MBS and Non-Agency adjustable-rate MBS had a weighted average term to next rate adjustment of approximately 23 months, while our borrowings had a weighted average term to next rate adjustment of 38 days. After adjusting for interest rate swap transactions, the weighted average term to next rate adjustment was 309 days. Accordingly, in a period of rising interest rates, we could experience a decrease in net income or a net loss because the interest rates on our borrowings adjust faster than the interest rates on our adjustable-rate MBS.

The MBS in which we invest and the mortgage loans underlying the MBS in which we invest are subject to delinquency, foreclosure and loss, which could result in losses to us.

Residential mortgage loans are secured by single-family residential property and are subject to risks of loss, delinquency and foreclosure. The ability of a borrower to repay a loan secured by a residential property is dependent upon the income or assets of the borrower. A number of factors, including a general economic downturn, acts of God, terrorism, social unrest and civil disturbances, may impair borrowers' abilities to repay their loans.

Residential MBS evidence interests in or are secured by pools of residential mortgage loans and collateralized MBS evidence interests in or are secured by a single commercial mortgage loan or a pool of commercial mortgage loans. Accordingly, the MBS we invest in are subject to all of the risks of the underlying

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mortgage loans. In the event of defaults with respect to the mortgage loans that underlie our MBS investments and the exhaustion of any underlying or additional credit support, we may not realize our anticipated return on these investments and we may incur a loss on these investments.

Increased levels of prepayments from MBS may decrease our net interest income.

Pools of mortgage loans underlie the MBS that we acquire. We generally receive payments from principal payments that are made on these underlying mortgage loans. When borrowers prepay their mortgage loans faster than expected, this results in prepayments that are faster than expected on the MBS. Faster than expected prepayments could harm our profitability as follows:

We usually purchase MBS that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we pay a premium over the par value to acquire the security. In accordance with accounting rules, we amortize this premium over the term of the mortgage-backed security. If the mortgage-backed security is prepaid in whole or in part prior to its maturity date, however, we expense the premium that was prepaid at the time of the prepayment. At December 31, 2009, substantially all of our MBS had been acquired at a premium.

We anticipate that a substantial portion of our adjustable-rate MBS may bear interest rates that are lower than their fully indexed rates, which are equivalent to the applicable index rate plus a margin. If an adjustable-rate mortgage-backed security is prepaid prior to or soon after the time of adjustment to a fully indexed rate, we will have held that mortgage-backed security while it was less profitable and lost the opportunity to receive interest at the fully indexed rate over the remainder of its expected life.

If we are unable to acquire new MBS similar to the prepaid MBS, our financial condition, results of operation and cash flow would suffer.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayment rates also may be affected by conditions in the housing and financial markets, general economic conditions and the relative interest rates on fixed-rate and adjustable-rate mortgage loans.

While we seek to minimize prepayment risk to the extent practical, in selecting investments, we must balance prepayment risk against other risks and the potential returns of each investment. No strategy can completely insulate us from prepayment risk.

We may experience reduced net interest income from holding fixed-rate investments during periods of rising interest rates.

We generally fund our acquisition of fixed-rate MBS with short-term borrowings. During periods of rising interest rates, our costs associated with borrowings used to fund acquisition of fixed-rate assets are subject to increases while the income we earn from these assets remains substantially fixed. This reduces or could eliminate the net interest spread between the fixed-rate MBS that we purchase and our borrowings used to purchase them, which could lower our net interest income or cause us to suffer a loss. At December 31, 2009, 13% of our Agency MBS were fixed-rate securities.

Interest rate caps on our adjustable-rate MBS may reduce our income or cause us to suffer a loss during periods of rising interest rates.

Our adjustable-rate MBS are subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount an interest rate can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through maturity of a mortgage-backed security. Our borrowings are not subject to similar restrictions. Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while interest rate caps would limit the interest rates on our

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adjustable-rate MBS. This problem is magnified for our adjustable-rate MBS that are not fully indexed. Further, some adjustable-rate MBS may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we could receive less cash income on adjustable-rate MBS than we need to pay interest on our related borrowings. These factors could lower our net interest income or cause us to suffer a loss during periods of rising interest rates. At December 31, 2009, approximately 87% of our Agency MBS were adjustable-rate securities.

We may invest in leveraged mortgage derivative securities that generally experience greater volatility in market prices, thus exposing us to greater risk with respect to their rate of return.

We may acquire leveraged mortgage derivative securities that may expose us to a high level of interest rate risk. The characteristics of leveraged mortgage derivative securities result in greater volatility in their market prices. Thus, acquisition of leveraged mortgage derivative securities would expose us to the risk of greater price volatility in our portfolio and that could harm our net income and overall profitability.

New assets we acquire may not generate yields as attractive or be as accretive to book value as have been experienced historically.

We may acquire new assets as we receive principal and interest payments and prepayments from our existing assets. We also sell assets from time to time as part of our portfolio and asset/liability management programs. We may invest these proceeds into new earning assets.

New assets may not generate yields as attractive as we have experienced historically. Business conditions, including credit results, prepayment patterns and interest rate trends in the future, may not be as favorable as they have been during the periods we held the replaced assets.

New assets may not be as accretive to book value as existing assets. The market value of our assets is sensitive to interest rate fluctuations. In the past as short-term interest rates increased, the market value of our existing assets has declined. As we classify our Agency MBS and Non-Agency MBS as available-for-sale, accounting regulations require that any unrealized losses from the decline in market value that are not considered to be an other-than-temporary impairment be carried as Accumulated other comprehensive loss in the Stockholders equity section of the consolidated balance sheets. When short-term interest rates stop increasing, or start declining, or when the interest rates on these securities reset, the market value of these assets may increase. This may be more accretive to book value than the new assets that we acquire to replace existing assets.

Risks Related to Our Management

Our officers devote a portion of their time to other companies in capacities that could create conflicts of interest that may harm our investment opportunities; this lack of a full-time commitment could also harm our operating results.

Lloyd McAdams, Joseph E. McAdams, Thad M. Brown, Bistra Pashamova and other of our officers and employees are officers and employees of Pacific Income Advisers, or PIA, where they devote a portion of their time. These officers and employees are under no contractual obligations mandating minimum amounts of time to be devoted to our company. In addition, a trust controlled by Lloyd McAdams is the principal stockholder of PIA.

These officers and employees are involved in investing both our assets and approximately \$4.4 billion in MBS and other fixed income assets for institutional clients and individual investors through PIA. These multiple responsibilities and ownerships may create conflicts of interest if these officers and employees of our company are presented with opportunities that may benefit both us and the clients of PIA. These officers allocate investments among our portfolio and the clients of PIA by determining the entity or account for which the

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investment is most suitable. In making this determination, these officers consider the investment strategy and guidelines of each entity or account with respect to acquisition of assets, leverage, liquidity and other factors that our officers determine appropriate. These officers, however, have no obligation to make any specific investment opportunities available to us and the above-mentioned conflicts of interest may result in decisions or allocations of securities that are not in our best interests.

Lloyd McAdams is also an owner and Chairman of Syndicated Capital, Inc., a registered broker-dealer. Syndicated Capital, Inc. has been authorized by our board of directors to act as the authorized broker on any buyback of the Company's common stock. Our officers' service to PIA and Syndicated Capital, Inc. allow them to spend only part of their time and effort managing our company, as they are required to devote a portion of their time and effort to the management of other companies, and this may harm our overall management and operating results.

Our board of directors may change our operating policies and strategies without prior notice or stockholder approval and such changes could harm our business, results of operation and stock price.

Our board of directors can modify or waive our current operating policies and our strategies without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies may have on our business, operating results and stock price, however, the effects may be adverse.

We depend on our key personnel and the loss of any of our key personnel could harm our operations.

We depend on the diligence, experience and skill of our officers and other employees for the selection, structuring and monitoring of our mortgage-related assets and associated borrowings. Our key officers include Lloyd McAdams, Chairman, President and Chief Executive Officer (Principal Executive Officer); Joseph E. McAdams, Chief Investment Officer, Executive Vice President and Director; Thad M. Brown, Chief Financial Officer (Principal Financial Officer), Treasurer and Secretary; Charles J. Siegel, Senior Vice President-Finance and Assistant Secretary; Bistra Pashamova, Senior Vice President; and Evangelos Karagiannis, Vice President. Our dependence on our key personnel is heightened by the fact that we have a relatively small number of employees and the loss of any key person could harm our entire business, financial condition, cash flow and results of operations. In particular, the loss of the services of Lloyd McAdams or Joseph E. McAdams could seriously harm our business.

Our incentive compensation arrangements may create incentives to increase the risk of our mortgage portfolio in an attempt to increase compensation.

In accordance with their employment agreements, two executive officers are eligible to participate in a performance-based bonus pool that is funded based on the company's return on average equity (ROAE). ROAE is calculated as the twelve-month GAAP net income excluding the effect of depreciation, preferred stock dividends, gains/losses on asset sales and impairment charges, divided by the average stockholder equity less goodwill and preferred stockholder equity. The aggregate amount of this performance-based bonus pool available for distribution to the executive officers can range annually based upon our ROAE. If the ROAE is 0% or less, no performance-based bonus is paid. If the ROAE is greater than 0% but less than 8%, a bonus pool of up to \$500 thousand is available in the aggregate. If the ROAE is 8% or greater, then the bonus pool available to be paid to both executive officers in the aggregate is \$500 thousand plus 10% of the first \$5 million of excess return and 6% of the amount of the excess return greater than \$5 million. Of the aggregate amount available for distribution from the bonus pool, the Compensation Committee bases annual bonus allocation to each of the participating executive officers on its assessment of the performance of each executive officer. 25% of any annual performance-based bonus amount over \$100 thousand will be paid in restricted shares (as opposed to cash). In an effort to earn greater amounts of incentive compensation under their employment agreements, as our executive officers evaluate different mortgage-related assets for our investment, there is a risk that they will cause us to

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assume more risk than is prudent. Prior to the end of any year, the Compensation Committee, at its discretion, may notify a participant that the participant will not participate in the pool during the following year. If this occurs, the sale or transfer restrictions on previously issued pool shares will be eliminated at that time.

In addition, certain management and key employees are eligible to earn incentive compensation for each fiscal year pursuant to our 2002 Incentive Compensation Plan, or the 2002 Incentive Plan. Under the 2002 Incentive Plan, the aggregate amount of compensation that may be earned by these employees equals a percentage of net income, before incentive compensation, in excess of the amount that would produce an annualized return on average net worth equal to the ten-year U.S. Treasury Rate plus 1%. In any fiscal quarter in which our net income is an amount less than the amount necessary to earn this threshold return, we calculate negative incentive compensation for that fiscal quarter which will be carried forward and will offset future incentive compensation earned under the 2002 Incentive Plan, but only with respect to those participants who were participants during the fiscal quarter(s) in which negative incentive compensation was generated. Although negative incentive compensation is used to offset future incentive compensation, as our management evaluates different mortgage-related assets for our investment, there is a risk that management will cause us to assume more risk than is prudent.

Risks Related to REIT Compliance and Other Tax Matters

If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.

We believe that, since our initial public offering in 1998, we have operated so as to qualify as a REIT under the Code and we intend to continue to meet the requirements for taxation as a REIT. Nevertheless, we may not remain qualified as a REIT in the future. Qualification as a REIT involves the application of highly technical and complex Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could require us to pay a penalty or jeopardize our REIT status. Furthermore, Congress or the IRS might change tax laws or regulations and the courts might issue new rulings, in each case potentially having retroactive effects that could make it more difficult or impossible for us to qualify as a REIT. If we fail to qualify as a REIT in any tax year, then:

we would be taxed as a regular domestic corporation, which, among other things, means being unable to deduct distributions to stockholders in computing taxable income and being subject to federal income tax on our taxable income at regular corporate rates;

any resulting tax liability could be substantial and would reduce the amount of cash available for distribution to stockholders; and

unless we were entitled to relief under applicable statutory provisions, we could be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which we lost our qualification and thus our cash available for distribution to stockholders would be reduced for each of the years during which we do not qualify as a REIT.

Complying with REIT requirements may cause us to forego otherwise attractive opportunities.

In order to qualify as a REIT for federal income tax purposes, we must continually satisfy tests concerning, among other things, our sources of income, the nature and diversification of our MBS and other assets, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may hinder our ability to operate solely on the basis of maximizing profits.

Complying with REIT requirements may limit our ability to hedge effectively.

The REIT provisions of the Code may substantially limit our ability to hedge MBS and related borrowings by requiring us to limit our income in each year from non-qualifying hedges, together with any other income not

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generated from qualified sources, to less than 25% of our gross income. In addition, we must limit our aggregate income from non-qualifying hedging, fees and certain other non-qualifying sources, other than from qualified REIT real estate assets or qualified hedges, to less than 5% of our annual gross income. As a result, we may in the future have to limit our use of advantageous hedging techniques or implement those hedges through a taxable REIT subsidiary. This could result in greater risks associated with changes in interest rates than we would otherwise want to incur. If we were to violate the 25% or 5% limitations, we may have to pay a penalty tax equal to the amount of income in excess of those limitations, multiplied by a fraction intended to reflect our profitability. If we fail to satisfy the 25% and 5% limitations, unless our failure was due to reasonable cause and not due to willful neglect, we could lose our REIT status for federal income tax purposes.

Complying with REIT requirements may force us to liquidate otherwise attractive investments or to make investments inconsistent with our business plan.

In order to qualify as a REIT, we must also determine that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets can consist of the securities of any one issuer. No more than 25% of the total value of our assets can be stock in taxable REIT subsidiaries. If we fail to comply with these requirements, we must dispose of a portion of our assets within 30 days after the end of the calendar quarter in order to avoid losing our REIT status and suffering adverse tax consequences. The need to comply with these gross income and asset tests may cause us to acquire other assets that are qualifying real estate assets for purposes of the REIT requirements that are not part of our overall business strategy and might not otherwise be the best investment alternative for us.

The IRS may challenge our determination that certain distributions are non-taxable returns of capital for shareholders.

In general, distributions by corporations are treated first as ordinary dividend income to the extent of the corporation's current or accumulated earnings and profits. When such corporate earnings and profits have been reduced to zero, further distributions are non-taxable returns of capital to the extent of the distributee shareholder's tax basis for its shares. Such return of capital distributions reduce the shareholder's tax basis for the shares. When tax basis for the shares has been reduced to zero, further distributions are treated as gain from the sale or exchange of the shares, which may be capital gain. Calculations of corporate earnings and profits are complex and the rules for such calculations are not entirely clear. In addition, calculations of current earnings and profits are made at the close of the corporation's taxable year without diminution by reason of any distributions made during the taxable year. The determination of whether there are current earnings and profits for the year is made without regard to the amount of the earnings and profits at the time in the year when the distribution was made. The IRS might disagree with our calculations of our earnings and profits and tax as a dividend a distribution that was intended to be a non-taxable return of capital. Some distributions during the corporation's tax year may appear to occur when there are no current or accumulated earnings and profits at the time of the distribution, but result in ordinary dividend income because of corporate earnings and profits that arise later in such year. Even when there are no current or accumulated corporate earnings and profits for the year of the distribution, the distribution will be a non-taxable return of capital only to the extent of the shareholder's tax basis for its shares. Tax basis could vary shareholder-by-shareholder and even share-by-share. The IRS recently published proposed regulations that would require a share-by-share determination so that a shareholder with varying tax bases for its shares could have ordinary dividend income with respect to some shares, even though the shareholder's aggregate tax basis for the shares would be sufficient to absorb the entire distribution. These proposed regulations would be effective for transactions that occur after the date the regulations are published as final regulations. As a result of the aforementioned rules, distributions by us that are intended to be non-taxable return of capital distributions to our shareholders may be taxable, in whole or in part, to some or all of the distributees.

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Complying with REIT requirements may force us to borrow to make distributions to stockholders.

As a REIT, we must distribute 90% of our annual taxable income (subject to certain adjustments) to our stockholders. From time to time, we may generate taxable income greater than our net income for financial reporting purposes from, among other things, amortization of capitalized purchase premiums, or our taxable income may be greater than our cash flow available for distribution to stockholders. For example, our taxable income would exceed our net income for financial reporting purposes to the extent that compensation paid to our Principal Executive Officer and our other four highest paid officers exceeds \$1 million for any such officer for any calendar year under Section 162(m) of the Code. Since payments under our 2002 Incentive Plan do not qualify as performance-based compensation under Section 162(m), a portion of the payments made under the 2002 Incentive Plan to certain of our officers would not be deductible for federal income tax purposes under such circumstances. If we do not have other funds available in these situations, we may be unable to distribute substantially all of our taxable income as required by the REIT provisions of the Code. Thus, we could be required to borrow funds, sell a portion of our MBS at disadvantageous prices or find another alternative source of funds. These alternatives could increase our costs or reduce our equity.

Dividends payable by REITs do not qualify for the reduced tax rates.

Tax legislation enacted in 2003 reduced the maximum U.S. federal tax rate on certain corporate dividends paid to individuals and other non-corporate taxpayers to 15% (through 2010). Dividends paid by REITs to these stockholders are generally not eligible for these reduced rates. Although this legislation does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable rates applicable to non-REIT corporate dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock.

The tax imposed on REITs engaging in prohibited transactions will limit our ability to engage in transactions, including certain methods of securitizing loans, which would be treated as sales for federal income tax purposes.

A REIT's net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property but including any mortgage loans, held in inventory primarily for sale to customers in the ordinary course of business. We might be subject to this tax if we were to sell a loan or securitize loans in a manner that was treated as a sale of such inventory for federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose not to engage in certain sales of loans other than through a taxable REIT subsidiary and may limit the structures we utilize for our securitization transactions even though such sales or structures might otherwise be beneficial for us. In addition, this prohibition may limit our ability to restructure our investment portfolio of mortgage loans from time to time, even if we believe that it would be in our best interest to do so.

Failure to maintain an exemption from the Investment Company Act would harm our results of operations.

We believe that we conduct our business in a manner that allows us to avoid being regulated as an investment company under the Investment Company Act of 1940, as amended. If we fail to continue to qualify for an exemption from registration as an investment company, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as planned. The Investment Company Act exempts entities that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Under the SEC's current interpretation, qualification for this exemption generally requires us to maintain at least 55% of our assets directly in qualifying real estate interests. MBS that do not represent all the certificates issued with respect to an underlying pool of mortgages may be treated as securities separate from the underlying mortgage loans and thus may not qualify for purposes of the 55% requirement. Therefore, our ownership of these MBS is limited by the Investment Company Act. In meeting the 55% requirement under the Investment Company Act, we treat as qualifying interests MBS issued with respect to

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an underlying pool for which we hold all issued certificates. If the SEC or its staff adopts a contrary interpretation, we could be required to sell a substantial amount of our MBS under potentially adverse market conditions. Further, in order to maintain our exemption from registration as an investment company, we may be precluded from acquiring MBS whose yield is somewhat higher than the yield on MBS that could be purchased in a manner consistent with the exemption.

We may incur excess inclusion income that would increase the tax liability of our stockholders.

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Code. If we realize excess inclusion income and allocate it to stockholders, however, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Code. If the stockholder is foreign, it would generally be subject to U.S. federal income tax withholding on this income without reduction pursuant to any otherwise applicable income tax treaty. U.S. stockholders would not be able to offset such income with their operating losses.

We generally structure our borrowing arrangements in a manner designed to avoid generating significant amounts of excess inclusion income. However, excess inclusion income could result if we held a residual interest in a REMIC. Excess inclusion income also may be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage loans or MBS securing those debt obligations. For example, we may engage in non-REMIC CMO securitizations. We also enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. The IRS may determine that these transactions give rise to excess inclusion income that should be allocated among our stockholders. We may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments. Some types of entities, including, without limitation, voluntarily employee benefit associations and entities that have borrowed funds to acquire their shares of our stock, may be required to treat a portion of or all of the dividends they receive from us as unrelated business taxable income.

Misplaced reliance on legal opinions or statements by issuers of MBS and government securities could result in a failure to comply with REIT gross income or asset tests.

When purchasing MBS and government securities, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents, for purposes of determining whether and to what extent those securities constitute REIT real estate assets for purposes of the REIT asset tests and produce income that qualifies under the REIT income tests. The inaccuracy of any such opinions or statements may harm our REIT qualification and result in significant corporate level tax.

Additional Risk Factors

We may not be able to use the money we raise from time to time to acquire investments at favorable prices.

We intend to seek to raise additional capital from time to time if we determine that it is in our best interests and the best interests of our stockholders, including through public offerings of our stock. The net proceeds of any offering could represent a significant increase in our equity. Depending on the amount of leverage that we use, the full investment of the net proceeds of any offering might result in a substantial increase in our total assets. There can be no assurance that we will be able to invest all of such additional funds in mortgage-related assets at favorable prices. We may not be able to acquire enough mortgage-related assets to become fully invested after an offering, or we may have to pay more for MBS than we have historically. In either case, the return that we earn on stockholders' equity may be reduced.

We have not established a minimum dividend payment level for our common stockholders and there are no assurances of our ability to pay dividends to them in the future.

We intend to pay quarterly dividends and to make distributions to our common stockholders in amounts such that all or substantially all of our taxable income in each year, subject to certain adjustments, is distributed.

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This, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Code. We have not established a minimum dividend payment level for our common stockholders and our ability to pay dividends may be harmed by the risk factors described in this Annual Report on Form 10-K. All distributions to our common stockholders will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of directors may deem relevant from time to time. There are no assurances of our ability to pay dividends in the future.

If we raise additional capital, our earnings per share and dividends per share may decline since we may not be able to invest all of the new capital during the quarter in which additional shares are sold and possibly the entire following calendar quarter.

Our charter does not permit ownership of over 9.8% of our common or preferred stock and attempts to acquire our common or preferred stock in excess of the 9.8% limit are void without prior approval from our board of directors.

For the purpose of preserving our REIT qualification and for other reasons, our charter prohibits direct or constructive ownership by any person of more than 9.8% of the lesser of the total number or value of the outstanding shares of our common stock or more than 9.8% of the outstanding shares of our preferred stock. Our charter's constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 9.8% of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 9.8% of the outstanding stock and thus be subject to our charter's ownership limit. Any attempt to own or transfer shares of our common or preferred stock in excess of the ownership limit without the consent of the board of directors shall be void and will result in the shares being transferred by operation of law to a charitable trust. Our board of directors has granted three unrelated third party institutional investors exemptions from the 9.8% ownership limitation as set forth in our charter documents. These exemptions permit one third party institutional investor to hold up to 15.0% of our common stock and two unrelated third party institutional investors to each hold up to 20.0% of our Series A Preferred Stock.

Because provisions contained in Maryland law, our charter and our bylaws may have an anti-takeover effect, investors may be prevented from receiving a control premium for their shares.

Provisions contained in our charter and bylaws, as well as Maryland corporate law, may have anti-takeover effects that delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a control premium for their shares. For example, these provisions may defer or prevent tender offers for our common stock or purchases of large blocks of our common stock, thereby limiting the opportunities for our stockholders to receive a premium for their common stock over then-prevailing market prices. These provisions include the following:

Ownership limit. The ownership limit in our charter limits related investors including, among other things, any voting group, from acquiring over 9.8% of our common stock or more than 9.8% of our preferred stock without our permission.

Preferred Stock. Our charter authorizes our board of directors to issue preferred stock in one or more classes and to establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval.

Maryland business combination statute. Maryland law restricts the ability of holders of more than 10% of the voting power of a corporation's shares to engage in a business combination with the corporation.

Maryland control share acquisition statute. Maryland law limits the voting rights of control shares of a corporation in the event of a control share acquisition.

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Future offerings of debt securities, which would be senior to our common stock, Series A Preferred Stock and Series B Preferred Stock upon liquidation, or equity securities, which would dilute our existing stockholders and may be senior to our common stock, Series A Preferred Stock and Series B Preferred Stock for the purposes of dividend distributions, may harm the market price of our common stock, Series A Preferred Stock or Series B Preferred Stock.

In the future, we may attempt to increase our capital resources by making additional offerings of debt or equity securities, including commercial paper, medium-term notes, senior or subordinated notes and classes of preferred stock or common stock. Upon liquidation, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets prior to the holders of our common stock. Our preferred stock may have a preference on dividend payments that could limit our ability to make a dividend distribution to the holders of our common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our common stockholders bear the risk of our future offerings reducing the market price of our common stock.

Our charter provides that we may issue up to 20 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to the Series A Preferred Stock or Series B Preferred Stock could have the effect of diluting the amounts we may have available for distribution to holders of the Series A Preferred Stock or Series B Preferred Stock. The Series A Preferred Stock and Series B Preferred Stock will be subordinated to all our existing and future debt. Thus, our Series A Preferred Stockholders and our Series B Preferred Stockholders bear the risk of our future offerings reducing the market price of our Series A Preferred Stock or Series B Preferred Stock.

We may issue additional shares of common stock or shares of preferred stock that are convertible into common stock. If we issue a significant number of shares of common stock or convertible preferred stock in a short period of time, there could be a dilution of the existing common stock and a decrease in the market price of the common stock.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We sublease approximately 5,500 square feet of office space in Santa Monica, California under a sublease agreement with PIA that expires in 2012. We believe this facility is adequate for our intended level of operations.

Item 3. LEGAL PROCEEDINGS

We are not a party to any material pending legal proceedings.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2009.

Table of Contents**PART II****Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Market Information**

Our common stock began trading under the symbol ANH on the New York Stock Exchange on May 9, 2003. Our common stock previously traded under the symbol ANH on the American Stock Exchange. Prior to March 17, 1998, there had been no public market for our common stock. The high and low sale prices for our common stock, as reported by the New York Stock Exchange, for the periods indicated are as follows:

	2009		2008	
	High	Low	High	Low
First Quarter	\$ 6.86	\$ 5.33	\$ 10.29	\$ 4.11
Second Quarter	\$ 7.25	\$ 6.02	\$ 7.25	\$ 6.24
Third Quarter	\$ 8.34	\$ 7.06	\$ 7.99	\$ 5.13
Fourth Quarter	\$ 8.12	\$ 6.80	\$ 6.82	\$ 4.23

Holders

As of February 23, 2010, there were approximately 1,138 record holders of our common stock. On February 23, 2010, the last reported sale price of our common stock on the New York Stock Exchange was \$6.68 per share.

Dividends

We pay cash dividends on a quarterly basis. The following table lists the cash dividends declared on each share of our common stock for our most recent two fiscal years. The dividends listed below were based primarily on the board of directors' evaluation of earnings and consideration of actions necessary to maintain our REIT status for each listed quarter and were declared on the date indicated:

	Cash Dividends Per Common Share	Date Dividends Declared
2009		
First quarter ended March 31, 2009	\$ 0.30	April 13, 2009
Second quarter ended June 30, 2009	\$ 0.32	July 10, 2009
Third quarter ended September 30, 2009	\$ 0.28	October 10, 2009
Fourth quarter ended December 31, 2009	\$ 0.28	December 16, 2009
2008		
First quarter ended March 31, 2008	\$ 0.20	April 11, 2008
Second quarter ended June 30, 2008	\$ 0.29	July 9, 2008
Third quarter ended September 30, 2008	\$ 0.25	October 16, 2008
Fourth quarter ended December 31, 2008	\$ 0.26	December 22, 2008

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The following graph presents a cumulative total shareholder return comparison of our common stock with the Standard & Poor's 500 Index and the National Association of Real Estate Investment Trusts, Inc. Mortgage REIT Index:

Total Return Performance

Index	Period Ending					
	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09
Anworth Mortgage Asset Corporation	100.00	74.38	92.97	83.16	74.32	102.35
S&P 500 Index	100.00	104.90	121.47	128.15	80.73	102.11
NAREIT Mortgage REIT Index	100.00	76.80	91.66	52.85	36.30	45.24

The cumulative total shareholder return reflects stock price appreciation, if any, and the value of dividends for our common stock and for each of the comparative indices. The graph assumes that \$100 was invested on December 31, 2004 in our common stock, that \$100 was invested in each of the indices on December 31, 2004 and that all dividends were reinvested into additional shares of common stock at the frequency with which dividends are paid on the common stock during the applicable fiscal year. The total return performance shown in this graph is not necessarily indicative of and is not intended to suggest future total return performance. Measurement points are at the last trading day of the fiscal years represented above.

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The selected financial data as of December 31, 2009 and 2008 and for the years ended December 31, 2009, 2008 and 2007 are derived from our audited financial statements included in this Annual Report on Form 10-K. The selected financial data as of December 31, 2007, 2006 and 2005 and for the years ended December 31, 2006 and 2005 are derived from audited financial statements not included in this Annual Report on Form 10-K. You should read these selected financial data together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our audited financial statements and notes thereto that are included in this Annual Report on Form 10-K beginning on page F-1.

	Year Ended December 31,				
	2009	2008	2007	2006	2005
	(amounts in thousands, except for per share data and days)				
Consolidated Statements of Income Data					
Days in period	365	366	365	365	365
Interest income net of amortization of premium and discount	\$ 262,029	\$ 287,698	\$ 248,831	\$ 206,287	\$ 159,248
Interest expense	(115,707)	(181,324)	(224,884)	(202,037)	(131,099)
Net interest income	\$ 146,322	\$ 106,374	\$ 23,947	\$ 4,250	\$ 28,149
Net (loss) on sale of assets		(49)	(23,442)	(10,207)	
Net gain (loss) on derivative instruments	107	(113)	(147)		
Impairment charges on Non-Agency MBS Expenses		(37,537)			
	(16,195)	(13,626)	(5,536)	(5,484)	(5,874)
Income (loss) from continuing operations	\$ 130,234	\$ 55,049	\$ (5,178)	\$ (11,441)	\$ 22,275
Income (loss) from discontinued operations(1)		7,558	(151,288)	(2,763)	6,610
Net income (loss)	\$ 130,234	\$ 62,607	\$ (156,466)	\$ (14,204)	\$ 28,885
Dividends on preferred stock	(5,906)	(5,928)	(4,749)	(4,044)	(3,901)
Net income (loss) available to common stockholders	\$ 124,328	\$ 56,679	\$ (161,215)	\$ (18,248)	\$ 24,984
Basic earnings (loss) per common share:					
Continuing operations	\$ 1.18	\$ 0.60	\$ (0.21)	\$ (0.34)	\$ 0.39
Discontinued operations		0.09	(3.26)	(0.06)	0.14
Total basic earnings (loss) per common share	\$ 1.18	\$ 0.69	\$ (3.47)	\$ (0.40)	\$ 0.53
Average number of shares outstanding	105,413	82,043	46,483	45,430	47,103
Diluted earnings (loss) per common share:					
Continuing operations	\$ 1.16	\$ 0.60	\$ (0.21)	\$ (0.34)	\$ 0.39
Discontinued operations		0.09	(3.26)	(0.06)	0.14
Total diluted earnings (loss) per common share	\$ 1.16	\$ 0.69	\$ (3.47)	\$ (0.40)	\$ 0.53
Average number of diluted shares outstanding	108,905	85,281	46,483	45,430	47,128

- (1) The year ended December 31, 2008 included a gain of approximately \$7.6 million on the disposition of discontinued operations, which is discussed in Note 15 to the accompanying audited financial statements.

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	2009	2008	As of December 31, 2007	2006	2005
	(amounts in thousands, except per share data)				
Consolidated Balance Sheets Data					
Agency MBS	\$ 6,485,801	\$ 5,307,440	\$ 4,662,547	\$ 4,678,907	\$ 4,524,683
Assets of discontinued operations			38	1,858,789	2,622,375
Total assets	\$ 6,526,648	\$ 5,477,142	\$ 4,797,519	\$ 6,687,389	\$ 7,184,249
Repurchase agreements	\$ 5,359,000	\$ 4,665,000	\$ 4,227,100	\$ 4,329,921	\$ 4,099,410
Junior subordinated notes	37,380	37,380	37,380	37,380	37,380
Liabilities of discontinued operations			7,834	1,756,060	2,517,727
Total liabilities	\$ 5,597,337	\$ 4,892,842	\$ 4,367,963	\$ 6,196,387	\$ 6,701,150
Series B Preferred Stock	25,803	28,096	28,108		
Stockholders' equity (common and Series A Preferred).	\$ 903,508	\$ 556,204	\$ 401,448	\$ 491,002	\$ 483,099
Number of common shares outstanding	115,563	90,462	57,289	45,609	45,397
Book value per common share	\$ 7.40	\$ 5.61	\$ 6.15	\$ 9.74	\$ 9.61

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Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our financial statements and the related notes included in Item 8 Financial Statements and Supplementary Data in this Annual Report on Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors including, but not limited to, those disclosed in Item 1A Risk Factors elsewhere in this Annual Report on Form 10-K and in other documents filed with the SEC and otherwise disclosed publicly.

General

We were formed in October 1997 and commenced operations on March 17, 1998. We are in the business of investing primarily in United States agency mortgage-backed securities, or MBS, which are obligations guaranteed by the United States government, such as Ginnie Mae, or federally sponsored enterprises such as Fannie Mae or Freddie Mac. Our principal business objective is to generate net income for distribution to stockholders based upon the spread between the interest income on our mortgage-related assets and the costs of borrowing to finance our acquisition of these assets.

We are organized for tax purposes as a real estate investment trust, or REIT. Accordingly, we generally distribute substantially all of our earnings to stockholders without paying federal or state income tax at the corporate level on the distributed earnings. At December 31, 2009, our qualified REIT assets (real estate assets, as defined in the Internal Revenue Code, or Code, cash and cash items and government securities) were greater than 90% of our total assets, as compared to the Code requirement that at least 75% of our total assets must be qualified REIT assets. Greater than 99% of our 2009 revenue qualifies for both the 75% source of income test and the 95% source of income test under the REIT rules. We believe we currently meet all REIT requirements regarding the ownership of our common stock and the distributions of our net income. Therefore, we believe that we continue to qualify as a REIT under the provisions of the Code.

During the past year, the credit and liquidity problems surrounding the mortgage markets and impacting the general economy have continued. This, along with other factors, has created great uncertainty in the financial markets in general and the related general economic recession. General downward economic trends, reduced availability of credit, increased unemployment and concerns over the economy have continued.

Although the U.S. government and other governments have taken various actions (including placing Fannie Mae and Freddie Mac in conservatorship) intended to protect financial institutions, their respective economies and their respective housing and mortgage markets, we continue to operate under very difficult market conditions. There can be no assurance that these various actions will have a beneficial impact on the global financial markets and, more specifically, the market for the securities we currently own in our portfolio. We cannot predict what, if any, impact these actions or future actions by either the U.S. government or foreign governments could have on our business, results of operations and financial condition. These events may impact the availability of financing generally in the marketplace and also may impact the market value of MBS generally, including the securities we currently own in our portfolio.

Our continuing operations consist of the following portfolios: agency mortgage-backed securities, or Agency MBS, and non-agency mortgage-backed securities, or Non-Agency MBS. Approximately 99.9% of our total portfolio is Agency MBS.

At December 31, 2009, we had total assets of \$6.53 billion. Our Agency MBS portfolio, consisting of \$6.49 billion, was distributed as follows: 25% adjustable-rate Agency MBS, 62% hybrid adjustable-rate Agency MBS, 13% fixed-rate Agency MBS and less than 1% agency floating-rate CMOs. Our Non-Agency MBS portfolio consisted of approximately \$4.7 million of floating-rate CMOs. Stockholders' equity available to common stockholders at December 31, 2009 was approximately \$854.7 million, or \$7.40 per share. The \$854.7 million

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equals total stockholders' equity of \$903.5 million less the Series A Preferred Stock liquidating value of approximately \$46.9 million and less the difference between the Series B Preferred Stock liquidating value of \$27.7 million and the proceeds from its sale of \$25.8 million. For the year ended December 31, 2009, we reported net income of \$130.2 million. Net income to common stockholders was \$124.3 million, or net income of \$1.16 per diluted share, based on a weighted average of 108.9 million fully diluted shares outstanding, which consisted of net income of \$130.2 million minus payment of preferred dividends of \$5.9 million.

Recently, Freddie Mac and Fannie Mae announced that they would be repurchasing seriously delinquent mortgage loans from the MBS pools which they guarantee. Based on the information provided by Fannie Mae and Freddie Mac, we expect that these buybacks will occur over a period of several months beginning March 2010. We expect that Fannie Mae's and Freddie Mac's buying seriously delinquent mortgages may result in an increase in prepayment rates in general and may impact our MBS portfolio.

As of December 31, 2009, 79% of Anworth's MBS were guaranteed by Fannie Mae and 21% were guaranteed by Freddie Mac. ARM loans are experiencing higher delinquency rates than fixed-rate loans, and loans originated in 2006 and 2007 are experiencing higher delinquency rates than loans originated in other years. The following table provides information about Anworth's MBS portfolio as of December 31, 2009.

Mortgage Type	Year of Origination	Portfolio Percentage (Based on 12/31/09 Principal Balance)
ARM	2009	7%
	2008	11%
	2007	21%
	2006	24%
	2005	12%
	2004 or earlier	11%
Fixed-Rate	All	13%

Results of Operations*Years Ended December 31, 2009 and 2008*

For the year ended December 31, 2009, our net income was \$130.2 million. Our net income available to common stockholders was \$124.3 million, or \$1.16 per diluted share, based on a weighted average of 108.9 million fully diluted shares outstanding. This includes net income of \$130.2 million minus the payment of preferred dividends of \$5.9 million. For the year ended December 31, 2008, our net income was \$62.6 million. Our net income available to common stockholders was \$56.7 million, or \$0.69 per diluted share, based on a weighted average of 85.3 million fully diluted shares outstanding. This includes net income of \$62.6 million minus the payment of preferred dividends of \$5.9 million.

Net interest income for the year ended December 31, 2009 totaled \$146.3 million or 51% of gross income, compared to \$106.4 million, or 36% of gross income, for the year ended December 31, 2008. Net interest income is comprised of the interest income earned on mortgage investments (net of premium amortization expense) less interest expense from borrowings. Interest income net of premium amortization expense for the year ended December 31, 2009 was \$262.0 million, compared to \$287.7 million for the year ended December 31, 2008, a decrease of 9% due primarily to a decrease in average coupons and an increase in premium amortization expense. Interest expense for the year ended December 31, 2009 was \$115.7 million, compared to \$181.3 million for the year ended December 31, 2008, a decrease of 36.2%, which resulted from a decline in short-term interest rates.

The results of our operations are affected by a number of factors, many of which are beyond our control, and primarily depend on, among other things, the level of our net interest income, the market value of our MBS, the supply of, and demand for, MBS in the marketplace, and the terms and availability of financing. Our net interest income varies primarily as a result from changes in interest rates, the slope of the yield curve (the differential between long-term and short-term interest rates), borrowing costs (our interest expense) and prepayment speeds.

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on our MBS portfolios, the behavior of which involves various risks and uncertainties. Interest rates and prepayment speeds, as measured by the constant prepayment rate, vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. With respect to our business operations, increases in interest rates, in general, may, over time, cause: (i) the interest expense associated with our borrowings, which are primarily comprised of repurchase agreements, to increase; (ii) the value of our MBS portfolios and, correspondingly, our stockholders' equity to decline; (iii) coupons on our MBS to reset, although on a delayed basis, to higher interest rates; (iv) prepayments on our MBS portfolios to slow, thereby slowing the amortization of our MBS purchase premiums; and (v) the value of our interest rate swap agreements and, correspondingly, our stockholders' equity to increase. Conversely, decreases in interest rates, in general, may, over time, cause: (i) prepayments on our MBS portfolios to increase, thereby accelerating the amortization of our MBS purchase premiums; (ii) the interest expense associated with our borrowings to decrease; (iii) the value of our MBS portfolios and, correspondingly, our stockholders' equity to increase; (iv) the value of our interest rate swap agreements and, correspondingly, our stockholders' equity to decrease; and (v) coupons on our MBS to reset, although on a delayed basis, to lower interest rates. In addition, our borrowing costs and credit lines are further affected by the type of collateral pledged and general conditions in the credit markets.

During the year ended December 31, 2009, premium amortization expense for Anworth increased \$11.8 million, or 98%, from \$12.0 million during the year ended December 31, 2008 to \$23.8 million.

The table below shows the approximate constant prepayment rate of our Agency MBS and Non-Agency MBS:

Portfolio	Year Ended December 31, 2009				Year Ended December 31, 2008			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Agency MBS and Non-Agency MBS	15%	17%	21%	19%	18%	18%	14%	10%

During the year ended December 31, 2009, we did not sell any Agency MBS. During the year ended December 31, 2008, we sold approximately \$26.6 million of Agency MBS (relating to the close-out of our repurchase agreement borrowings with Lehman Brothers Special Finance), resulting in a loss of approximately \$49 thousand. These sales were in connection with the bankruptcy of Lehman Brothers Holdings Inc. and we do not anticipate any other sales in connection with bankruptcies unless one of our other counterparties defaults.

During the year ended December 31, 2009, we did not recognize through earnings any impairment charges. During the year ended December 31, 2008, we had recognized through earnings impairment charges of approximately \$38 million on our Non-Agency MBS portfolio, with approximately \$34 million being recognized during the third quarter ended September 30, 2008 and approximately \$4 million being recognized during the fourth quarter ended December 31, 2008. Of these amounts, approximately \$22 million had previously been shown as unrealized loss in other comprehensive income of stockholders' equity at June 30, 2008. As we believed this decline in fair value was likely to be other-than-temporary, we recognized an impairment charge to write these securities down to their estimated fair value. Some of the factors considered in our assessment included: (1) the expected cash flows from these investments; (2) whether there has been an other-than-temporary deterioration of the credit quality of the underlying mortgages; (3) the credit protection available to the related mortgage pools; (4) any other market information available; (5) management's internal analysis of the securities considering all relevant information at the time of the assessment; and (6) the magnitude and duration of the historical decline in market prices. Because our assessment is based on both factual and subjective information available at the time of the assessment, the determination of the amount considered impaired is subjective and therefore constitutes material estimates that are susceptible to significant change.

During the year ended December 31, 2009, there was a net gain of approximately \$107 thousand recognized in earnings due to hedge ineffectiveness, compared to a net loss of approximately \$113 thousand due to hedge ineffectiveness during the year ended December 31, 2008. We have determined that our hedges are still considered highly effective. There were no components of the derivative instruments' gain or loss excluded from the assessment of hedge effectiveness.

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In September 2008, the assets of Belvedere Trust and the assets of BT Management Company, L.L.C., or BT Management, were assigned for the benefit of their creditors to an independent third party. As control of these operations was turned over to this third party, Belvedere Trust and BT Management were deconsolidated, and we recognized a gain on the disposition of discontinued operations of approximately \$7.6 million during the year ended December 31, 2008. As a result, there were no remaining assets or liabilities of discontinued operations at December 31, 2008.

Total expenses were \$16.2 million for the year ended December 31, 2009, compared to \$13.6 million for the year ended December 31, 2008. The increase of \$2.6 million in total expenses was due primarily to an increase in compensation costs of \$1.8 million (due to increased bonuses and incentive compensation), the write-down of a receivable from Lehman Brothers, Inc. of approximately \$962 thousand and partially offset by a decrease in Other expenses (as detailed in Note 13 to the accompanying audited financial statements) of \$73 thousand and the write-off in 2008 of common stock offering costs of \$114 thousand.

Years Ended December 31, 2008 and 2007

For the year ended December 31, 2008, our net income was \$62.6 million. Our net income available to common stockholders was \$56.7 million, or \$0.69 per diluted share, based on a weighted average of 85.3 million fully diluted shares outstanding. This includes net income of \$62.6 million minus the payment of preferred dividends of \$5.9 million. For the year ended December 31, 2007, our net loss was \$156.5 million. Our 2007 net loss to common stockholders was \$161.2 million, or a net loss of \$(3.47) per diluted share, based on an average of 46.5 million shares outstanding. The 2007 loss includes a loss from continuing operations of \$5.2 million (due primarily to a loss of \$23.4 million on the sale of approximately \$904 million of our Agency MBS and Non-Agency MBS) and a loss from discontinued operations of \$151.3 million (due to the sales and seizures by lenders and write-offs of the assets of Belvedere Trust Mortgage Corporation and subsidiaries, or Belvedere Trust).

Net interest income for the year ended December 31, 2008 totaled \$106.4 million or 36% of gross income, compared to \$23.9 million, or 8.9% of gross income, for the year ended December 31, 2007. The increase in net interest income is due primarily to the increase in our investments in Agency MBS (based on leverage on approximately \$250 million in capital raised during the year ended December 31, 2008). Interest income net of premium amortization expense for the year ended December 31, 2008 was \$287.7 million, compared to \$248.8 million for the year ended December 31, 2007, an increase of 16% (due primarily to an increase in the size of the portfolio). Interest expense for the year ended December 31, 2008 was \$181.3 million, compared to \$224.9 million for the year ended December 31, 2007, a decrease of 19%, which resulted from a decline in short-term interest rates.

During the year ended December 31, 2008, premium amortization expense for Anworth decreased \$9.1 million, or 43%, from \$21.1 million during the year ended December 31, 2007 to \$12.0 million. During the year ended December 31, 2008, the decrease in premium amortization expense for Anworth resulted from a decrease in the constant prepayment rate, or CPR, of our portfolio.

The table below shows the approximate constant prepayment rate of our Agency MBS and Non-Agency MBS:

Portfolio	Year Ended December 31, 2008				Year Ended December 31, 2007			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Agency MBS and Non-Agency MBS	18%	18%	14%	10%	24%	25%	23%	18%

During the year ended December 31, 2008, we sold approximately \$26.6 million of Agency MBS (relating to the close-out of our repurchase agreement borrowings with Lehman Brothers Special Finance), resulting in a loss of approximately \$49 thousand. These sales were in connection with the bankruptcy of Lehman Brothers Holdings Inc. and we do not anticipate any other sales in connection with bankruptcies unless one of our other

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counterparties defaults. During the year ended December 31, 2007, we sold approximately \$904 million of Agency MBS and Non-Agency MBS, resulting in a loss of approximately \$23.4 million. The sales in 2007 were in response to liquidity concerns in the marketplace.

During the year ended December 31, 2008, there was a net loss of approximately \$113 thousand recognized in earnings due to hedge ineffectiveness, compared to a net loss of approximately \$147 thousand due to hedge ineffectiveness during the year ended December 31, 2007. We have determined that our hedges are still considered highly effective. There were no components of the derivative instruments gain or loss excluded from the assessment of hedge effectiveness.

In September 2008, the assets of Belvedere Trust and the assets of BT Management Company, L.L.C., or BT Management, were assigned for the benefit of their creditors to an independent third party. As control of these operations was turned over to this third party, Belvedere Trust and BT Management have been deconsolidated, and we recognized a gain on the disposition of discontinued operations of approximately \$7.6 million during the year ended December 31, 2008. As a result, there were no remaining assets or liabilities of discontinued operations at December 31, 2008. At December 31, 2007, there were approximately \$38 thousand in assets of discontinued operations and approximately \$7.8 million in liabilities of discontinued operations.

Total expenses were \$13.6 million for the year ended December 31, 2008, compared to \$5.5 million for the year ended December 31, 2007. The increase of \$8.1 million in total expenses was due primarily to an increase in compensation costs of \$1.6 million (due to increased salaries and bonuses), the payment of \$5.8 million in incentive compensation (primarily related to and in accordance with senior executive employment agreements), an increase in Other expenses (as detailed in Note 13 to the accompanying audited financial statements) of \$248 thousand, an increase in compensation costs relating to amortization of restricted stock of \$299 thousand and the write-off of common stock offering costs of \$114 thousand.

Financial Condition

Agency MBS Portfolio

At December 31, 2009, we held agency mortgage assets whose amortized cost was approximately \$6.31 billion, consisting primarily of \$5.5 billion of adjustable-rate Agency MBS, \$806 million of fixed-rate Agency MBS and \$6 million of floating-rate CMOs. This amount represents an approximate 20% increase from the \$5.26 billion held at December 31, 2008. Of the adjustable-rate Agency MBS owned by us, 30% were adjustable-rate pass-through certificates whose coupons reset within one year. The remaining 70% consisted of hybrid adjustable-rate Agency MBS whose coupons will reset between one year and five years. Hybrid adjustable-rate Agency MBS have an initial interest rate that is fixed for a certain period, usually three to five years, and thereafter adjust annually for the remainder of the term of the loan.

The following table presents a schedule of our Agency MBS at fair value owned at December 31, 2009 and December 31, 2008, classified by type of issuer (dollar amounts in thousands):

Agency	December 31, 2009		December 31, 2008	
	Fair Value	Portfolio Percentage	Fair Value	Portfolio Percentage
Fannie Mae (FNM)	\$ 5,113,407	78.8%	\$ 3,971,748	74.8%
Freddie Mac (FHLMC)	1,350,448	20.8	1,309,149	24.7
Ginnie Mae (GNMA)	21,946	0.4	26,543	0.5
Total Agency MBS:	\$ 6,485,801	100%	\$ 5,307,440	100%

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The following table classifies our portfolio of Agency MBS owned at December 31, 2009 and December 31, 2008, by type of interest rate index (dollar amounts in thousands):

Agency	December 31, 2009		December 31, 2008	
	Fair Value	Portfolio Percentage	Fair Value	Portfolio Percentage
One-month LIBOR	\$ 5,661	0.1%	\$ 7,669	0.2%
Six-month LIBOR	138,715	2.1	43,192	0.8
One-year LIBOR	4,982,800	76.8	3,690,221	69.5
Six-month certificate of deposit	1,426		1,653	0.1
Six-month constant maturity treasury	559		671	
One-year constant maturity treasury	476,461	7.4	478,422	9.0
Cost of Funds Index	33,405	0.5	38,972	0.7
Fixed-rate	846,774	13.1	1,046,640	19.7
Total Agency MBS:	\$ 6,485,801	100%	\$ 5,307,440	100%

The fair values indicated do not include interest earned but not yet paid. With respect to our hybrid adjustable-rate Agency MBS, the fair value of these securities appears on the line associated with the index based on which the security will eventually reset once the initial fixed interest rate period has expired. The fair value of our Agency MBS is reported to us independently from dealers who are major financial institutions and are considered to be market makers for these types of instruments. For more detail on the fair value of our Agency MBS, see Note 5 to the accompanying audited consolidated financial statements.

At December 31, 2009, our total Agency MBS portfolio had a weighted average coupon of 5.08%. The average coupon of the adjustable-rate securities was 4.11%, the hybrid securities average coupon was 5.35%, the fixed-rate securities average coupon was 5.79% and the CMO floaters average coupon was 1.04%. At December 31, 2008, our total Agency MBS portfolio had a weighted average coupon of 5.54%. The average coupon of the adjustable-rate securities was 5.19%, the hybrid securities average coupon was 5.56%, the fixed-rate securities average coupon was 5.79% and the CMO floaters average coupon was 2.01%.

At December 31, 2009, the average amortized cost of our agency mortgage-related assets was 102.03%, the average amortized cost of our adjustable-rate securities was 102.23% and the average amortized cost of our fixed-rate securities was 100.69%. Relative to our Agency MBS portfolio at December 31, 2009, the average interest rate on outstanding repurchase agreements was 0.24% and the average days to maturity was 38 days. After adjusting for interest rate swap transactions, the average interest rate on outstanding repurchase agreements was 1.88% and the weighted average term to next rate adjustment was 309 days.

At December 31, 2008, the average amortized cost of our agency mortgage-related assets was 101.22%, the average amortized cost of our adjustable-rate securities was 101.35% and the average amortized cost of our fixed-rate securities was 100.68%. Relative to our Agency MBS portfolio at December 31, 2008, the average interest rate on outstanding repurchase agreements was 2.07% and the average days to maturity was 34 days. After adjusting for interest rate swap transactions, the average interest rate on outstanding repurchase agreements was 3.25% and the weighted average term to next rate adjustment was 422 days.

At December 31, 2009 and December 31, 2008, the unamortized net premium paid for our Agency MBS was approximately \$118 million and \$63 million, respectively.

At December 31, 2009, the current yield on our Agency MBS portfolio was 4.98%, based on a weighted average coupon of 5.08% divided by the average amortized cost of 102.03%. At December 31, 2008, the current yield on our Agency MBS portfolio was 5.47%, based on a weighted average coupon of 5.54% divided by the average amortized cost of 101.22%.

One of the factors that impacts the reported yield on our MBS portfolio is the actual prepayment rate on the underlying mortgages. We analyze our MBS and the extent to which prepayments impact the yield. When the

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rate of prepayments exceeds expectations, we amortize the premiums paid on mortgage assets over a shorter time period, resulting in a reduced yield to maturity on our mortgage assets. Conversely, if actual prepayments are less than the assumed CPR, the premium would be amortized over a longer time period, resulting in a higher yield to maturity.

Non-Agency MBS Portfolio

At December 31, 2009, our Non-Agency MBS portfolio consisted of a fair value of \$4.7 million of floating-rate CMOs with an average coupon of 0.48%, which were acquired at par value. At December 31, 2008, our Non-Agency MBS portfolio consisted of a fair value of \$7.3 million of floating-rate CMOs with an average coupon of 0.72%, which were acquired at par value. Non-Agency MBS are securities not issued by the government or government-sponsored enterprises and are secured primarily by first-lien residential mortgage loans.

At December 31, 2009, the fair value of our Non-Agency MBS portfolio declined to approximately \$4.7 million, from a fair value of approximately \$7.3 million at December 31, 2008. The detail of this decline is shown on page F-21 to the accompanying audited consolidated financial statements.

At December 31, 2009, a security representing approximately 33% of the principal balance of our Non-Agency MBS portfolio was rated CCC by Standard & Poor's and a security representing approximately 67% of the principal balance of our Non-Agency MBS portfolio was downgraded from CCC to CC by Standard & Poor's. At December 31, 2009, Moody's Investor Service rated these two securities as Ca.

We received valuations at December 31, 2008 for the Non-Agency MBS from an independent third party pricing service whose methodologies are based on broker-provided pricing as well as indirect observation of market activity. Generally, we would consider this to be a Level 2 input. However, given the severely reduced trading activity surrounding the Non-Agency MBS, which limited the observability of significant inputs utilized in valuing these securities, we reduced the fair value measurement to a Level 3 input at December 31, 2008 and it remains a Level 3 input at December 31, 2009. For more detail on the fair value of our Non-Agency MBS, see Note 5 to the accompanying audited consolidated financial statements.

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The table below provides additional details regarding our Non-Agency MBS portfolio at December 31, 2009 and December 31, 2008:

	December 31, 2009	December 31, 2008
Non-Agency MBS at fair value	\$ 4.7 million	\$ 7.34 million
Principal balance of Non-Agency MBS	\$ 41.79 million	\$ 44.87 million
Original principal balance on Non-Agency MBS	\$ 60 million	\$ 60 million
Original FICO (credit score)	730	730
<i>Information on Loan Collateral of Non-Agency MBS Securitizations</i>		
Loan principal as percentage of original loan principal	69.7%	76.3%
Weighted average original loan-to-value (LTV)	69%	69%
Weighted average original LTV adjusted for negative loan amortization	73%	73%
California loans(1)	69%	68%
Pay-option ARM loans(1)	100%	100%
2006 loan originations(1)	99%	99%
3-month CPR	13.1%	7.4%
Loans in foreclosure(1)	16.5%	6.0%
Real estate owned (REO)(1)(2)	3.5%	2.4%
Total seriously delinquent(1)(3)	27.2%	12.3%
Realized losses (as percentage of original collateral balance)	3.6%	0.5%
<i>Information on Subordination Levels of Non-Agency MBS Securitizations(4)</i>		
Average securitization principal subordinate to Anworth-owned tranches	6.0%	9.5%
Average securitization principal of Anworth-owned tranches	16.1%	15.5%
Average securitization principal senior to Anworth-owned tranches	77.9%	75.0%

(1) As a percentage of collateral loan principal.

(2) Represents the amount of collateral loan principal where the properties are now REO.

(3) Includes 90+ days delinquent plus foreclosures plus bankruptcy plus REO.

(4) Weighted average as percentage of collateral loan principal at December 31, 2009 and December 31, 2008.

Hedging

We periodically enter into derivative transactions, in the form of forward purchase commitments and interest rate swaps, which are intended to hedge our exposure to rising rates on funds borrowed to finance our investments in securities. We designate interest rate swap transactions as cash flow hedges. We also periodically enter into derivative transactions, in the form of forward purchase commitments, which are not designated as hedges. To the extent that we enter into hedging transactions to reduce our interest rate risk on indebtedness incurred to acquire or carry real estate assets, any income or gain from the disposition of hedging transactions should be qualifying income under the REIT rules for purposes of the 95% gross income test. The hedging rules that exclude certain hedging income from the computation of the 95% income test have been extended to exclusion under the 75% income test as well. To qualify for this exclusion, the hedging transaction must be clearly identified as such before the close of the day on which it was acquired, originated or entered into. The transaction must hedge indebtedness incurred or to be incurred by us to acquire or carry real estate assets.

As part of our asset/liability management policy, we may enter into hedging agreements such as interest rate caps, floors or swaps. These agreements are entered into to try to reduce interest rate risk and are designed to provide us with income and capital appreciation in the event of certain changes in interest rates. We review the need for hedging agreements on a regular basis consistent with our capital investment policy. At December 31, 2009, we were a counter-party to swap agreements, which are derivative instruments as defined by the Financial Accounting Standards Board in Accounting Standards Classification, or ASC, No. 815-10, with an aggregate

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notional amount of \$2.32 billion and an average maturity of 1.9 years. We utilize swap agreements to manage interest rate risk and do not anticipate entering into derivative transactions for speculative or trading purposes. In accordance with the swap agreements, we pay a fixed rate of interest during the term of the swap agreements and receive a payment that varies with the three-month LIBOR rate. At December 31, 2009, there were unrealized losses of approximately \$81.5 million on our swap agreements.

For more information on the amounts, policies, objectives and other qualitative data on our hedge agreements, see Note 1, Note 5 and Note 11 to the accompanying audited consolidated financial statements.

Liquidity and Capital Resources

Agency MBS and Non-Agency MBS Portfolios

Our primary source of funds consists of repurchase agreements which totaled \$5.36 billion at December 31, 2009. As collateral for these repurchase agreements, we have pledged approximately \$5.75 billion in Agency MBS. Our other significant source of funds for the year ended December 31, 2009 consisted of payments of principal from our Agency MBS portfolio in the amount of \$1.09 billion.

For the year ended December 31, 2009, there was a net decrease in cash and cash equivalents of approximately \$130.2 million. This consisted of the following components:

Net cash provided by operating activities for the year ended December 31, 2009 was approximately \$211.8 million. This is comprised primarily of net income of \$130.2 million, adding back the following non-cash items: the amortization of premium and discounts of approximately \$23.8 million, the write-down on the Lehman receivable of approximately \$962 thousand, the amortization of restricted stock of \$282 thousand, non-cash incentive compensation of approximately \$1.3 million, less the net gain on derivative instruments of approximately \$107 thousand. Net cash provided by operating activities also included an increase in accrued expenses of approximately \$62.9 million, partially offset by a decrease in accrued interest payable of approximately \$4.9 million and an increase in interest receivable of \$2.7 million;

Net cash used in investing activities for the year ended December 31, 2009 was approximately \$1.1 billion, which consisted of purchases of Agency MBS of approximately \$2.2 billion, partially offset by \$1.1 billion from principal payments on Agency MBS; and

Net cash provided by financing activities for the year ended December 31, 2009 was approximately \$730 million. This consisted of borrowings on repurchase agreements of approximately \$29.174 billion, partially offset by repayments on repurchase agreements of approximately \$28.48 billion, net proceeds from common stock issued of approximately \$161 million and net proceeds from the issuance of Series B Preferred Stock of approximately \$1 million less dividends paid of \$120 million on common stock and dividends paid of approximately \$5.9 million on preferred stock.

Relative to our Agency MBS portfolio at December 31, 2009, all of our repurchase agreements were fixed-rate term repurchase agreements with original maturities ranging from 18 days to three months. At December 31, 2009, we had borrowed funds under repurchase agreements with 16 different financial institutions. As the repurchase agreements mature, we enter into new repurchase agreements to take their place. Because we borrow money based on the fair value of our MBS and because increases in short-term interest rates or increasing market concern about the liquidity or value of our MBS can negatively impact the valuation of MBS, our borrowing ability could be reduced and lenders may initiate margin calls in the event short-term interest rates increase or the value of our MBS declines for other reasons. We had adequate cash flow, liquid assets and unpledged collateral with which to meet our margin requirements during the year ended December 31, 2009 but there can be no assurance we will have adequate cash flow, liquid assets and unpledged collateral with which to meet our margin requirements in the future.

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Our leverage on capital (including all preferred stock and junior subordinated notes) decreased from 7.5x at December 31, 2008 to 5.5x at December 31, 2009. During the past year, we have borrowed, on a short-term basis, between five to seven times the amount of our equity allocated to these investments, as management believed it to be appropriate to lower our leverage due to the uncertainty in the financial marketplace and the broader problems in the economy.

In the future, we expect that our primary sources of funds will continue to consist of borrowed funds under repurchase agreement transactions and of monthly payments of principal and interest on our MBS portfolios. Our liquid assets generally consist of unpledged MBS, cash and cash equivalents. A large negative change in the market value of our MBS might reduce our liquidity, requiring us to sell assets with the likely result of realized losses upon sale.

During the year ended December 31, 2009, we raised approximately \$65.8 million in capital under our Dividend Reinvestment and Stock Purchase Plan.

On February 9, 2009, we issued an aggregate of 8 million shares of common stock and recognized net proceeds of approximately \$46 million (net of underwriting fees, commissions and other costs). We used all of the net proceeds from the offering to acquire Agency MBS. At December 31, 2009, our authorized capital included 20 million shares of \$0.01 par value preferred stock, which we have classified as Series A Cumulative Preferred Stock, or Series A Preferred Stock, and Series B Cumulative Convertible Preferred Stock, or Series B Preferred Stock. During the year ended December 31, 2009, we did not issue any shares of Series A Preferred Stock. During the year ended December 31, 2009, we issued 41.2 thousand shares of Series B Preferred Stock and recognized net proceeds of approximately \$1 million.

During the year ended December 31, 2009, we issued 6.736 million shares of common stock under our Controlled Equity Offering Sales Agreement, or the Program, with Cantor Fitzgerald & Co., or Cantor (as described in Note 8 to the accompanying audited consolidated financial statements), which provided net proceeds to us of approximately \$48.8 million, net of sales commissions and less reimbursement of fees and also net of other costs. Cantor, as sales agent, received an aggregate commission of approximately \$998 thousand, which represents an average commission of approximately 2.0% on the gross sales price per share. During the year ended December 31, 2009, we sold 41.2 thousand shares of our Series B Preferred Stock under the Program, which provided net proceeds to us of approximately \$1 million, net of sales commissions less reimbursement of fees. The sales agent received an aggregate of approximately \$20.5 thousand, which represents an average commission of approximately 2.0% on the gross sales price per share. At December 31, 2009, there were 5,101,900 shares of common stock, 1,225,000 shares of Series A Preferred Stock and 1,902,800 shares of Series B Preferred Stock, respectively, available under the Program.

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The following table represents our contractual obligations at December 31, 2009 (in thousands):

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Repurchase agreements(1)	\$ 5,359,000	\$ 5,359,000	\$	\$	\$
Junior subordinated notes(2)	37,380				37,380
Lease commitment	772	302	470		
Total(3)	\$ 5,397,152	\$ 5,359,302	\$ 470	\$	\$ 37,380

(1) These represent amounts due by maturity.

(2) These represent amounts due by contractual maturity. However, we do have the option to redeem these after March 30, 2010 and April 30, 2010 as more fully described in Note 4 to the accompanying audited consolidated financial statements.

(3) This does not include annual compensation agreements and incentive compensation agreements, which are more fully described in Note 9 to the accompanying audited consolidated financial statements.

Stockholders' Equity

We use available-for-sale treatment for our Agency MBS and Non-Agency MBS, which are carried on our balance sheet at fair value rather than historical cost. Based upon these treatments, our total equity base at December 31, 2009 was \$903.5 million. Common stockholders' equity was approximately \$854.7 million, or \$7.40 book value per share.

Under our available-for-sale accounting treatment, unrealized fluctuations in fair values of assets are assessed to determine whether they are other-than-temporary. To the extent we determine that these unrealized fluctuations are not other-than-temporary, they do not impact GAAP income or taxable income but rather are reflected on the balance sheet by changing the carrying value of the assets and reflecting the change in stockholders' equity under Accumulated other comprehensive income, unrealized gain (loss) on available-for-sale securities.

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting on all of our assets. As a result, comparisons with some companies that use historical cost accounting for all of their balance sheet may not be meaningful.

Unrealized changes in the fair value of MBS have one significant and direct effect on our potential earnings and dividends: positive mark-to-market changes will increase our equity base and allow us to increase our borrowing capacity, while negative changes will tend to reduce borrowing capacity under our capital investment policy. A very large negative change in the net market value of our MBS might reduce our liquidity, requiring us to sell assets with the likely result of realized losses upon sale. Accumulative other comprehensive income, unrealized gain on available-for-sale Agency MBS was approximately \$165.3 million, or 2.62% of the amortized cost of our Agency MBS, at December 31, 2009. This, along with Accumulative other comprehensive loss, derivatives of approximately \$81.5 million and Accumulated other comprehensive gain, Non-Agency MBS of \$0.5 million, constitutes the total Accumulative other comprehensive income of approximately \$84.3 million.

Critical Accounting Policies

Management has the obligation to ensure that its policies and methodologies are in accordance with GAAP. Management has reviewed and evaluated its critical accounting policies and believes them to be appropriate.

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The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying audited consolidated financial statements. In preparing these audited consolidated financial statements, management has made its best estimates and judgments on the basis of information then readily available to it of certain amounts included in the audited consolidated financial statements, giving due consideration to materiality. We do not believe that there is a great likelihood that materially different amounts would be reported related to accounting policies described below. Nevertheless, application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ materially and adversely from these estimates.

Our accounting policies are described in Note 1 to the accompanying audited consolidated financial statements. Management believes the more significant of our accounting policies are the following:

Revenue Recognition

The most significant source of our revenue is derived from our investments in MBS. We reflect income using the effective yield method which, through amortization of premiums and accretion of discounts at an effective yield, recognizes periodic income over the estimated life of the investment on a constant yield basis, as adjusted for actual prepayment activity. Management believes our revenue recognition policies are appropriate to reflect the substance of the underlying transactions.

Interest income on our MBS is accrued based on the actual coupon rate and the outstanding principal amounts of the underlying mortgages. Premiums and discounts are amortized or accreted into interest income over the expected lives of the securities using the effective interest yield method, adjusted for the effects of actual prepayments and estimated prepayments based on ASC 320-10. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, street consensus prepayment speeds and current market conditions. If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

Valuation and Classification of Investment Securities

We carry our investment securities on the balance sheet at fair value. The fair values of our Agency MBS are generally based on third party bid price indications provided by certain dealers who make markets in such securities. The fair value of our Non-Agency MBS are obtained from an independent third party pricing service whose methodologies are based on broker-provided pricing as well as indirect observation of market activity. If, in the opinion of management, one or more securities prices reported to us are not reliable or unavailable, management reviews the fair value based on characteristics of the security it receives from the issuer and available market information. The fair values reported reflect estimates and may not necessarily be indicative of the amounts we could realize in a current market exchange. We review various factors (i.e., expected cash flows, changes in interest rates, credit protection, etc.) in determining whether and to what extent an other-than-temporary impairment exists. To the extent that unrealized losses on our Agency MBS and Non-Agency MBS are attributable to changes in interest rates and not credit quality, and because we do not have the intent to sell these investments nor is it not more likely than not that we will be required to sell these investments before recovery of their amortized cost bases, which may be at maturity, we do not consider these investments to be other-than-temporarily impaired. Losses (that are related to credit quality) on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from Accumulated other comprehensive income to current-period income. For more detail on the fair value of our securities, see Note 5 to the accompanying audited consolidated financial statements.

Accounting for Derivatives and Hedging Activities

In accordance with ASC 815-10, a derivative that is designated as a hedge is recognized as an asset/liability and measured at estimated fair value. In order for our interest rate swap agreements to qualify for hedge accounting, upon entering into the swap agreement, we must anticipate that the hedge will be highly effective, as defined by ASC 815-10.

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On the date we enter into a derivative contract, we designate the derivative as a hedge of the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a cash flow hedge). Changes in the fair value of a derivative that are highly effective and that are designated and qualify as a cash flow hedge, to the extent that the hedge is effective, are recorded in Other comprehensive income and reclassified to income when the forecasted transaction affects income (e.g., when periodic settlement interest payments are due on repurchase agreements). The swap agreements are carried on our consolidated balance sheets at their fair value based on values obtained from large financial institutions, who are market makers for these types of instruments. Hedge ineffectiveness, if any, is recorded in current-period income.

We formally assess, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions have been highly effective in offsetting changes in the cash flows of hedged items and whether those derivatives may be expected to remain highly effective in future periods. If it is determined that a derivative is not (or has ceased to be) highly effective as a hedge, we discontinue hedge accounting.

When we discontinue hedge accounting, the gain or loss on the derivative remains in Accumulated other comprehensive income and is reclassified into income when the forecasted transaction affects income. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, we will carry the derivative at its fair value on the balance sheet, recognizing changes in the fair value in current-period income.

For purposes of the cash flow statement, cash flows from derivative instruments are classified with the cash flows from the hedged item.

Income Taxes

Our financial results do not reflect provisions for current or deferred income taxes. Management believes that we have and intend to continue to operate in a manner that will allow us to be taxed as a REIT and, as a result, management does not expect to pay substantial, if any, corporate level taxes. Many of these requirements, however, are highly technical and complex. If we were to fail to meet these requirements, we would be subject to federal income tax.

Subsequent Events

We have evaluated subsequent events through February 26, 2010, which is the date that our consolidated financial statements are issued. For purposes of these financial statements, we have not evaluated any subsequent events after this date.

On January 27, 2010, we declared a Series A Preferred Stock dividend of \$0.539063 per share and a Series B Preferred Stock dividend of \$0.390625 per share, each of which is payable on April 15, 2010 to our holders of record of Series A Preferred Stock and Series B Preferred Stock, respectively, as of the close of business on March 31, 2010.

On January 27, 2010, our board of directors authorized the Company to acquire up to 5,850,000 shares of our common stock, or approximately 5% of our total shares of common stock outstanding, through a stock repurchase plan. The shares are expected to be acquired at prevailing prices through open market transactions. The manner, price, number and timing of share repurchases will be subject to market conditions and applicable SEC rules. From January 1, 2010 through February 25, 2010, we had repurchased an aggregate of 173 thousand shares of our common stock at an average price of \$6.92 per share under this program.

From January 1, 2010 through February 25, 2010, there were three transactions to convert an aggregate of 6,700 shares of Series B Preferred Stock into an aggregate of 21,105 shares of our common stock (based on the then current conversion rate of 3.1505).

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Item 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

We seek to manage the interest rate, market value, liquidity, prepayment and credit risks inherent in all financial instruments in a prudent manner designed to insure our longevity while, at the same time, seeking to provide an opportunity for stockholders to realize attractive total rates of return through ownership of our common stock. While we do not seek to avoid risk completely, we do seek, to the best of our ability, to assume risk that can be quantified from historical experience, to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

Interest Rate Risk

We primarily invest in adjustable-rate, hybrid and fixed-rate mortgage-related assets. Hybrid mortgages are ARMs that have a fixed interest rate for an initial period of time (typically three years or greater) and then convert to an adjustable-rate for the remaining loan term. Our debt obligations are generally repurchase agreements of limited duration that are periodically refinanced at current market rates.

ARM-related assets are typically subject to periodic and lifetime interest rate caps that limit the amount an ARM-related asset's interest rate can change during any given period. ARM securities are also typically subject to a minimum interest rate payable. Our borrowings are not subject to similar restrictions. Hence, in a period of increasing interest rates, interest rates on our borrowings could increase without limitation, while the interest rates on our mortgage-related assets could be limited. This problem would be magnified to the extent we acquire mortgage-related assets that are not fully indexed. Further, some ARM-related assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would negatively impact our liquidity, net income and our ability to make distributions to stockholders.

We fund the purchase of a substantial portion of our ARM-related assets with borrowings that have interest rates based on indices and repricing terms similar to, but of shorter maturities than, the interest rate indices and repricing terms of our mortgage assets. Thus, we anticipate that in most cases the interest rate indices and repricing terms of our mortgage assets and our funding sources will not be identical, thereby creating an interest rate mismatch between assets and liabilities. During periods of changing interest rates, such interest rate mismatches could negatively impact our net interest income, dividend yield and the market price of our common stock.

Most of our adjustable-rate assets are based on the one-year constant maturity treasury rate and the one-year LIBOR rate and our debt obligations are generally based on LIBOR. These indices generally move in the same direction, but there can be no assurance that this will continue to occur.

Our ARM-related assets and borrowings reset at various different dates for the specific asset or obligation. In general, the repricing of our debt obligations occurs more quickly than on our assets. Therefore, on average, our cost of funds may rise or fall more quickly than does our earnings rate on the assets.

Further, our net income may vary somewhat as the spread between one-month interest rates and six- and twelve-month interest rates varies.

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At December 31, 2009, our Agency MBS and Non-Agency MBS and related borrowings will prospectively reprice based on the following time frames (dollar amounts in thousands):

	Investments(1)(2)		Borrowings	
	Amount	Percentage of Total Investments	Amount	Percentage of Total Borrowings
Investment Type/Rate Reset Dates:				
Fixed-rate investments	\$ 846,774	13.1%	\$	
Adjustable-Rate Investments/Obligations:				
Less than 3 months	302,345	4.7	5,359,000	100.0%
Greater than 3 months and less than 1 year	1,343,012	20.7		
Greater than 1 year and less than 2 years	1,414,173	21.8		
Greater than 2 years and less than 3 years	1,422,397	21.9		
Greater than 3 years and less than 5 years	1,161,842	17.8		
Total:	\$ 6,490,543	100.0%	\$ 5,359,000	100.0%

(1) Based on when they contractually reprice and do not consider the effect of any prepayments.

(2) The Company assumes that if the repricing of the investment is just beyond 3 months but less than 4 months, it is included in the Less than 3 months category.

At December 31, 2008, our Agency MBS and Non-Agency MBS and related borrowings will prospectively reprice based on the following time frames (dollar amounts in thousands):

	Investments(1)(2)		Borrowings	
	Amount	Percentage of Total Investments	Amount	Percentage of Total Borrowings
Investment Type/Rate Reset Dates:				
Fixed-rate investments	\$ 1,046,640	19.7%	\$	
Adjustable-Rate Investments/Obligations:				
Less than 3 months	351,344	6.6	4,545,000	97.4%
Greater than 3 months and less than 1 year	475,668	9.0	120,000	2.6
Greater than 1 year and less than 2 years	308,400	5.8		
Greater than 2 years and less than 3 years	1,078,142	20.3		
Greater than 3 years and less than 5 years	2,054,583	38.7		
Total:	\$ 5,314,777	100.0%	\$ 4,665,000	100.0%

(1) Based on when they contractually reprice and do not consider the effect of any prepayments.

(2) The Company assumes that if the repricing of the investment is just beyond 3 months but less than 4 months, it is included in the Less than 3 months category.

Market Value Risk

All of our MBS are classified as available-for-sale assets. As such, they are reflected at fair value (i.e., market value) with the periodic adjustment to fair value (that is not considered to be an other-than-temporary impairment) reflected as part of Accumulated other comprehensive income that is included in the equity section of our balance sheet. The market value of our assets can fluctuate due to changes in interest rates and other factors.

Liquidity Risk

Our primary liquidity risk arises from financing long-maturity MBS with short-term debt. The interest rates on our borrowings generally adjust more frequently than the interest rates on our adjustable-rate MBS. For

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example, at December 31, 2009, our Agency MBS and Non-Agency adjustable-rate MBS had a weighted average term to next rate adjustment of approximately 23 months while our borrowings had a weighted average term to next rate adjustment of 38 days. After adjusting for interest rate swap transactions, the weighted average term to next rate adjustment was 309 days. Accordingly, in a period of rising interest rates, our borrowing costs will usually increase faster than our interest earnings from MBS. As a result, we could experience a decrease in net income or a net loss during these periods. Our assets that are pledged to secure short-term borrowings are high-quality liquid assets. As a result, we have been able to roll over our short-term borrowings as they mature. There can be no assurance that we will always be able to roll over our short-term debt.

During the year ended December 31, 2009, there were continuing liquidity and credit concerns surrounding the mortgage markets generally and continuing concerns about the general economy. While the U.S. government and other governments have taken various actions to address these concerns, there continue to be severe restrictions on the availability of financing in general and concerns about the potential impact on product availability, liquidity, interest rates and changes in the yield curve. While we have been able to meet all of our liquidity needs to date, there are still concerns in the mortgage sector about the availability of financing generally.

At December 31, 2009, we had unrestricted cash of \$1.8 million and \$730 million in unpledged Agency MBS and Non-Agency MBS available to meet margin calls on short-term borrowings that could be caused by asset value declines or changes in lender collateralization requirements.

Prepayment Risk

Prepayments are the full or partial repayment of principal prior to the original term to maturity of a mortgage loan and typically occur due to refinancing of mortgage loans. Prepayment rates on mortgage-related securities and mortgage loans vary from time to time and may cause changes in the amount of our net interest income. Prepayments of ARM loans usually can be expected to increase when mortgage interest rates fall below the then-current interest rates on such loans and decrease when mortgage interest rates exceed the then-current interest rate on such loans, although such effects are not entirely predictable. Prepayment rates may also be affected by the conditions in the housing and financial markets, general economic conditions and the relative interest rates on fixed-rate loans and ARM loans underlying MBS. The purchase prices of MBS are generally based upon assumptions regarding the expected amounts and rates of prepayments. Where slow prepayment assumptions are made, we may pay a premium for MBS. To the extent such assumptions differ from the actual amounts of prepayments, we could experience reduced earnings or losses. The total prepayment of any MBS purchased at a premium by us would result in the immediate write-off of any remaining capitalized premium amount and a reduction of our net interest income by such amount. In addition, in the event that we are unable to acquire new MBS to replace the prepaid MBS, our financial condition, cash flows and results of operations could be harmed.

We often purchase mortgage-related assets that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we must pay a premium over par value to acquire these assets. In accordance with accounting rules, we amortize this premium over the term of the MBS. As we receive repayments of mortgage principal, we amortize the premium balances as a reduction to our income. If the mortgage loans underlying MBS were prepaid at a faster rate than we anticipate, we would amortize the premium at a faster rate. This would reduce our income.

General

Many assumptions are made to present the information in the tables below 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; therefore, the tables below and all related disclosures constitute forward-looking statements. The analyses presented utilize assumptions and estimates based on management's judgment and experience. Furthermore,

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future sales, acquisitions and restructuring could materially change the interest rate risk profile for us. The tables quantify the potential changes in net income and net asset value should interest rates immediately change (are shocked). The results of interest rate shocks of plus and minus 100 and 200 basis points are presented. The cash flows associated with the portfolio of mortgage-related assets for each rate shock are calculated based on a variety of assumptions including prepayment speeds, time until coupon reset, yield on future acquisitions, slope of the yield curve and size of the portfolio. Assumptions made on the interest rate-sensitive liabilities, which are repurchase agreements, include anticipated interest rates (no negative rates are utilized), collateral requirements as a percent of the repurchase agreement and amount of borrowing. Assumptions made in calculating the impact on net asset value of interest rate shocks include interest rates, prepayment rates and the yield spread of mortgage-related assets relative to prevailing interest rates.

Tabular Presentation

The information presented in the table below projects the impact of sudden changes in interest rates on Anworth's annual Projected Net Interest Income and Projected Portfolio Value as more fully discussed below, based on investments in place at December 31, 2009, and includes all of our interest rate-sensitive assets, liabilities and hedges, such as interest rate swap agreements.

Changes in Projected Net Interest Income equals the change that would occur in the calculated Projected Net Interest Income for the next twelve months relative to the 0% change scenario if interest rates were to instantaneously parallel shift to and remain at the stated level for the next twelve months.

Changes in Projected Portfolio Value equals the change in value of our assets that we carry at fair value and any change in the value of any derivative instruments or hedges, such as interest rate swap agreements. We acquire interest rate-sensitive assets and fund them with interest rate-sensitive liabilities. We generally plan to retain such assets and the associated interest rate risk to maturity.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change In Projected Portfolio Value
2%	32.5%	0.3%
1%	8.0%	0.5%
0%		
1%	7.6%	2.0%
2%	20.0%	4.6%

When interest rates are shocked, prepayment assumptions are adjusted based on management's best estimate of the effects of changes in interest rates on prepayment speeds. For example, under current market conditions, a 100 basis point decline in interest rates is estimated to result in a 72.3% increase in the prepayment rate of our Agency MBS and Non-Agency portfolios. The base interest rate scenario assumes interest rates at December 31, 2009. Actual results could differ significantly from those estimated in the table. The above table includes the effect of interest rate swap agreements. At December 31, 2009, the aggregate notional amount of the interest rate swap agreements was \$2.32 billion and the weighted average maturity was 1.9 years.

The information presented in the table below projects the impact of sudden changes in interest rates on Anworth's annual Projected Net Income and Projected Portfolio Value compared to the base case used in the table above and excludes the effect of the interest rate swap agreements.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change In Projected Portfolio Value
2%	17.3%	0.9%
1%	41.9%	1.2%
0%		
1%	28.1%	2.6%
2%	4.3%	5.9%

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Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and related financial information required to be filed hereunder are indexed under Item 15 of this Annual Report on Form 10-K and are incorporated herein by reference.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls

We maintain disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

Our management, with the participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on such evaluation, our Principal Executive Officer and Principal Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective.

Management Report on Internal Control Over Financial Reporting

The management of Anworth is responsible for establishing and maintaining adequate internal control over financial reporting. Anworth's internal control system was designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation and fair presentation of prepared financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2009. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on our assessment, we believe that, as of December 31, 2009, Anworth's internal control over financial reporting is effective based on those criteria.

The Company's independent auditors, McGladrey & Pullen, LLP, have issued an attestation report on the effectiveness of the Company's internal control over financial reporting. This report appears on page 67 of this Annual Report on Form 10-K.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders

Anworth Mortgage Asset Corporation

We have audited Anworth Mortgage Asset Corporation (the Company) s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Item 9A, Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of Anworth Mortgage Asset Corporation for the years ended December 31, 2009 and 2008 and our report dated February 26, 2010, expressed an unqualified opinion.

McGladrey & Pullen, LLP

Irvine, California

February 26, 2010

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Item 9B. OTHER INFORMATION

None.

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PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference from the information under the captions entitled Election of Directors Information Regarding Nominees for Director, Executive Officers and Section 16(a) Beneficial Ownership Reporting Compliance in our definitive proxy statement to be filed with the SEC no later than April 30, 2010.

Item 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference from the information under the caption entitled Executive Compensation in our definitive proxy statement to be filed with the SEC no later than April 30, 2010.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Certain of the information required by this Item is incorporated by reference from the information under the caption entitled Security Ownership of Certain Beneficial Owners and Management in our definitive proxy statement to be filed with the SEC no later than April 30, 2010.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated by reference from the information under the caption entitled Certain Transactions and Relationships in our definitive proxy statement to be filed with the SEC no later than April 30, 2010.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated by reference from the information under the caption entitled Principal Accountant Fees and Services in our definitive proxy statement to be filed with the SEC no later than April 30, 2010.

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PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of this report:

(1) The following financial statements of the Company are included in Part II, Item 8 of this Annual Report on Form 10-K:

Report of Independent Registered Public Accounting Firm, McGladrey & Pullen, LLP;
Report of Independent Registered Public Accounting Firm, BDO Seidman, LLP;
Consolidated Balance Sheets as of December 31, 2009 and December 31, 2008;
Consolidated Statements of Income: Years Ended December 31, 2009, December 31, 2008 and December 31, 2007;
Consolidated Statements of Stockholders' Equity: Years Ended December 31, 2009, December 31, 2008 and December 31, 2007;
Consolidated Statements of Cash Flows: Years Ended December 31, 2009, December 31, 2008 and December 31, 2007; and
Notes to Consolidated Financial Statements.

(2) Schedules to financial statements:

All financial statement schedules have been omitted because they are either inapplicable or the information required is provided in the Company's Consolidated Financial Statements and Notes thereto, included in Part II, Item 8 of this Annual Report on Form 10-K.

(3) The exhibits listed on the accompanying Exhibit Index are filed as part of this Annual Report on Form 10-K.

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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.

DATED: February 26, 2010

ANWORTH MORTGAGE ASSET CORPORATION

/s/ JOSEPH LLOYD McADAMS

Joseph Lloyd McAdams

Chairman of the Board, President and

Chief Executive Officer

(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ JOSEPH LLOYD McADAMS Joseph Lloyd McAdams	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	February 26, 2010
/s/ THAD M. BROWN Thad M. Brown	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 26, 2010
/s/ JOSEPH E. McADAMS Joseph E. McAdams	Executive Vice President, Chief Investment Officer and Director	February 26, 2010
/s/ LEE A. AULT, III Lee A. Ault, III	Director	February 26, 2010
/s/ CHARLES H. BLACK Charles H. Black	Director	February 26, 2010
/s/ JOE E. DAVIS Joe E. Davis	Director	February 26, 2010
/s/ ROBERT C. DAVIS Robert C. Davis	Director	February 26, 2010

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

Anworth Mortgage Asset Corporation

We have audited the accompanying consolidated balance sheets of Anworth Mortgage Asset Corporation and subsidiaries (the Company) as of December 31, 2009 and 2008, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2009 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 26, 2010 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

McGladrey & Pullen, LLP

Irvine, California

February 26, 2010

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Anworth Mortgage Asset Corporation

Santa Monica, California

We have audited the accompanying consolidated statements of income, comprehensive income, stockholders' equity, and cash flows of Anworth Mortgage Asset Corporation (Anworth) for the year ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of its operations and its cash flows for the year ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

Los Angeles, California

February 26, 2010

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share amounts)

	December 31, 2009	December 31, 2008
ASSETS		
Agency MBS:		
Agency MBS pledged to counterparties at fair value	\$ 5,749,849	\$ 5,164,178
Agency MBS at fair value	725,174	137,966
Paydowns receivable	10,778	5,296
	6,485,801	5,307,440
Non-Agency MBS:		
Non-Agency MBS at fair value	4,742	7,337
Cash and cash equivalents	1,812	131,970
Interest and dividends receivable	28,818	26,081
Derivative instruments at fair value	2,059	
Prepaid expenses and other	3,416	4,314
Total Assets:	\$ 6,526,648	\$ 5,477,142
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Accrued interest payable	\$ 20,838	\$ 26,268
Repurchase agreements	5,359,000	4,665,000
Junior subordinated notes	37,380	37,380
Derivative instruments at fair value	82,811	138,592
Dividends payable on Series A Preferred Stock	1,011	1,011
Dividends payable on Series B Preferred Stock	433	471
Dividends payable on common stock	32,305	23,445
Accrued expenses and other	63,559	675
Total Liabilities:	\$ 5,597,337	\$ 4,892,842
Series B Cumulative Convertible Preferred Stock: par value \$0.01 per share; liquidating preference \$25.00 per share (\$27,700 and \$30,138, respectively); 1,108 and 1,206 shares issued and outstanding at December 31, 2009 and December 31, 2008, respectively	\$ 25,803	\$ 28,096
Stockholders' Equity:		
Series A Cumulative Preferred Stock: par value \$0.01 per share; liquidating preference \$25.00 per share (\$46,888 and \$46,888, respectively); 1,876 and 1,876 shares issued and outstanding at December 31, 2009 and December 31, 2008, respectively	\$ 45,397	\$ 45,397
Common Stock: par value \$0.01 per share; authorized 200,000 shares, 115,563 and 90,462 issued and outstanding at December 31, 2009 and December 31, 2008, respectively	1,156	905
Additional paid-in capital	1,016,821	851,588
Accumulated other comprehensive gain (loss) consisting of unrealized losses and gains	84,259	(101,940)
Accumulated deficit	(244,125)	(239,746)
Total Stockholders' Equity:	\$ 903,508	\$ 556,204
Total Liabilities and Stockholders' Equity:	\$ 6,526,648	\$ 5,477,142

See accompanying notes to consolidated financial statements.

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Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME (LOSS)**

(in thousands, except per share amounts)

	For the Year Ended December 31,		
	2009	2008	2007
Interest income net of amortization of premium and discount:			
Interest on Agency MBS	\$ 261,625	\$ 285,687	\$ 242,779
Interest on Non-Agency MBS	255	1,309	4,978
Other income	149	702	1,074
	262,029	287,698	248,831
Interest expense:			
Interest expense on repurchase agreements	114,158	178,875	221,697
Interest expense on junior subordinated notes	1,549	2,449	3,187
	115,707	181,324	224,884
Net interest income	146,322	106,374	23,947
(Loss) on sale of Agency MBS and Non-Agency MBS		(49)	(23,442)
Net gain (loss) on derivative instruments	107	(113)	(147)
Impairment charges on Non-Agency MBS		(37,537)	
Expenses:			
Compensation, incentive compensation and benefits	(11,868)	(10,074)	(2,346)
Write-down of Lehman receivable	(962)		
Write-off of common stock offering costs		(114)	
Other expenses	(3,365)	(3,438)	(3,190)
Total expenses	(16,195)	(13,626)	(5,536)
Income (loss) from continuing operations	130,234	55,049	(5,178)
(Loss) from discontinued operations			(151,288)
Gain on disposition of discontinued operations		7,558	
Net income (loss)	\$ 130,234	\$ 62,607	\$ (156,466)
Dividend on Series A Cumulative Preferred Stock	(4,044)	(4,044)	(3,033)
Dividend on Series B Cumulative Convertible Preferred Stock	(1,862)	(1,884)	(1,716)
Net income (loss) to common stockholders	\$ 124,328	\$ 56,679	\$ (161,215)
Basic earnings (loss) per common share:			
Continuing operations	\$ 1.18	\$ 0.60	\$ (0.21)
Discontinued operations		0.09	(3.26)
Total basic earnings (loss) per common share	\$ 1.18	\$ 0.69	\$ (3.47)
Diluted earnings (loss) per common share:			

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Continuing operations	\$	1.16	\$	0.60	\$	(0.21)
Discontinued operations				0.09		(3.26)
Total diluted earnings (loss) per common share	\$	1.16	\$	0.69	\$	(3.47)
Basic weighted average number of shares outstanding		105,413		82,043		46,483
Diluted weighted average number of shares outstanding		108,905		85,281		46,483

See accompanying notes to consolidated financial statements.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years ended December 31, 2009, 2008 and 2007

(in thousands, except per share amounts)

	Series A Preferred Stock Shares	Common Stock Shares	Series A Preferred Stock Par Value	Common Stock Par Value	Additional Paid-In Capital	Accum. Other Comp. Income (Loss) MBS	Accum. Other Comp. Income (Loss) Non-Agency MBS	Accum. Other Comp. Income (Loss) Derivatives	Accum. Other Comp. Income (Loss) BT Other MBS	Accum. Income (Deficit)	Comp. Income (Loss)	Total
Balance, December 31, 2006	1,876	45,609	\$ 45,397	\$ 456	\$ 525,607	\$ (50,519)	\$	\$	4,882	\$ 202	\$ (35,023)	\$ 491,002
Issuance of common stock		11,680		117	75,873							75,990
Other comprehensive income (loss), fair value adjustments and reclassifications						64,770	(7,003)	(48,259)	(202)		9,306	9,306
Net loss										(156,466)	(156,466)	(156,466)
Comprehensive loss											\$ (147,160)	
Amortization of restricted stock					(18)							(18)
Dividend declared \$2.156252 per Series A preferred share										(3,033)		(3,033)
Dividend declared \$1.453993 per Series B preferred share										(1,716)		(1,716)
Dividend declared \$0.27 per common share										(13,617)		(13,617)
Balance, December 31, 2007	1,876	57,289	\$ 45,397	\$ 573	\$ 601,462	\$ 14,251	\$ (7,003)	\$ (43,377)	\$	\$ (209,855)		\$ 401,448
Issuance of common stock		33,173		332	249,844							250,176
Other comprehensive income (loss), fair value adjustments and reclassifications						23,599	7,003	(96,413)			(65,811)	(65,811)
Net income										62,607	62,607	62,607
Comprehensive loss											\$ (3,204)	

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Amortization of restricted stock						282						282
Dividend declared \$2.156252 per Series A preferred share									(4,044)			(4,044)
Dividend declared \$1.562500 per Series B preferred share									(1,884)			(1,884)
Dividend declared \$1.00 per common share									(86,570)			(86,570)
Balance, December 31, 2008	1,876	90,462	\$ 45,397	\$ 905	\$ 851,588	\$ 37,850	\$	\$ (139,790)	\$	\$ (239,746)		\$ 556,204
Issuance of common stock		25,101		251	164,951							165,202
Other comprehensive income, fair value adjustments and reclassifications						127,400	492	58,307			186,199	186,199
Net income										130,234	130,234	130,234
Comprehensive income											\$ 316,433	
Amortization of restricted stock						282						282
Dividend declared \$2.156252 per Series A preferred share									(4,044)			(4,044)
Dividend declared \$1.5625 per Series B preferred share									(1,862)			(1,862)
Dividend declared \$1.18 per common share									(128,707)			(128,707)
Balance, December 31, 2009	1,876	115,563	\$ 45,397	\$ 1,156	\$ 1,016,821	\$ 165,250	\$ 492	\$ (81,483)	\$	\$ (244,125)		\$ 903,508

See accompanying notes to consolidated financial statements.

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	For the Year Ended December 31,		
	2009	2008	2007
Operating Activities:			
Net income (loss)	\$ 130,234	\$ 62,607	\$ (5,178)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Amortization of premium and discounts (Agency MBS)	23,849	11,991	21,092
Impairment charges on Non-Agency MBS		37,537	
Write-down of Lehman receivable	962		
Loss on sale of Agency MBS and Non-Agency MBS		49	23,442
(Gain) loss on derivative instruments	(107)	113	147
Amortization of restricted stock	282	282	(18)
Non-cash incentive compensation	1,315	1,800	
Gain on disposition of discontinued operations		(7,558)	
Changes in assets and liabilities:			
(Increase) decrease in interest receivable	(2,737)	(463)	1,511
(Increase) decrease in prepaid expenses and other	(64)	49,872	(48,745)
(Decrease) in accrued interest payable	(4,857)	(15,960)	(19,727)
Increase (decrease) in accrued expenses and other	62,884	(632)	(1,279)
Net cash (used in) provided by operating activities of discontinued operations		(44)	(29,864)
Net cash provided by (used in) operating activities	\$ 211,761	\$ 139,594	\$ (58,619)
Investing Activities:			
Available-for-sale Agency MBS:			
Purchases	\$ (2,165,101)	\$ (1,568,755)	\$ (2,047,388)
Principal payments	1,090,292	908,480	1,235,399
Proceeds from sales		24,956	858,019
Available-for-sale Non-Agency MBS:			
Purchases			(20,000)
Principal payments	3,087	4,841	21,828
Proceeds from sales			46,047
Net cash provided by investing activities of discontinued operations			494,702
Net cash (used in) provided by investing activities	\$ (1,071,722)	\$ (630,478)	\$ 588,607
Financing Activities:			
Borrowings from repurchase agreements	\$ 29,173,931	\$ 29,498,118	\$ 28,320,977
Repayments on repurchase agreements	(28,479,931)	(29,060,218)	(28,423,798)
Proceeds from common stock issued, net	160,598	248,354	75,990
Proceeds on Series B Preferred Stock issued, net	996		28,108
Series A Preferred stock dividends paid	(4,044)	(4,044)	(4,044)
Series B Preferred stock dividends paid	(1,900)	(1,884)	(1,245)
Common stock dividends paid	(119,847)	(69,889)	(7,764)
Net cash (used in) financing activities of discontinued operations			(505,947)
Net cash provided by (used in) financing activities	\$ 729,803	\$ 610,437	\$ (517,723)

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Net (decrease) increase in cash and cash equivalents	\$ (130,158)	\$ 119,553	\$ 12,265
Cash and cash equivalents at beginning of period	131,970	12,440	34
Add: net decrease (increase) in cash of discontinued operations		(23)	141
Cash and cash equivalents at end of period	\$ 1,812	\$ 131,970	\$ 12,440

Supplemental Disclosure of Cash Flow Information:

Cash paid for interest	\$ 120,563	\$ 195,785	\$ 244,611
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Supplemental Disclosure of Investing and Financing Activities:

Deconsolidation of variable interest entities	\$	\$	\$ 1,214,452
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See accompanying notes to consolidated financial statements.

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Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(in thousands)**

	For the Year Ended December 31,		
	2009	2008	2007
Net income (loss)	\$ 130,234	\$ 62,607	\$ (156,466)
Available-for-sale Agency MBS, fair value adjustment	127,400	23,550	50,759
Reclassification adjustment for losses on sales of Agency MBS included in net income (loss)		49	14,011
Available-for-sale Non-Agency MBS, fair value adjustment	492	(30,534)	(16,434)
Impairment charge on Non-Agency MBS included in net income		37,537	
Reclassification adjustment for losses on sales of Non-Agency MBS included in net loss			9,431
Unrealized (losses) on cash flow hedges	(24,012)	(128,705)	(39,790)
Reclassification adjustment for (gains) losses on derivative instruments	(107)	113	147
Reclassification adjustment for interest (income) expense included in net income (loss)	82,426	32,179	(8,616)
BT Other MBS, fair value adjustment			(202)
	186,199	(65,811)	9,306
Comprehensive income (loss)	\$ 316,433	\$ (3,204)	\$ (147,160)

See accompanying notes to consolidated financial statements.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Anworth Mortgage Asset Corporation, or Anworth, was incorporated in Maryland on October 20, 1997 and commenced operations on March 17, 1998. We are in the business of investing primarily in United States, or U.S., agency mortgage-backed securities, or Agency MBS. Agency MBS are securities representing obligations guaranteed by the U.S. government, such as Ginnie Mae, or guaranteed by federally sponsored enterprises, such as Fannie Mae or Freddie Mac. We seek long-term investment returns by investing our equity capital and borrowed funds in such securities and other mortgage-related assets.

We have elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, or the Code. As a REIT, we routinely distribute substantially all of the income generated from our operations to our stockholders. As long as we retain our REIT status, we generally will not be subject to federal or state taxes on our income to the extent that we distribute our net income to our stockholders.

BASIS OF PRESENTATION AND CONSOLIDATION

The accompanying consolidated financial statements are prepared on the accrual basis of accounting in accordance with generally accepted accounting principles utilized in the United States of America, or GAAP. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Material estimates that are susceptible to change relate to the determination of the fair value of securities, amortization of security premiums and accretion of security discounts, accounting for derivatives and hedging activities and accounting for impaired securities. Actual results could materially differ from these estimates. Significant intercompany accounts and transactions have been eliminated. In the opinion of management, all material adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less. The carrying amount of cash equivalents approximates their fair value.

Reverse Repurchase Agreements

We use securities purchased under agreements to resell, or reverse repurchase agreements, as a means of investing excess cash. Although legally structured as a purchase and subsequent resale, reverse repurchase agreements are treated as financing transactions under which the counterparty pledges securities (principally U.S. treasury securities) and accrued interest as collateral to secure a loan. The difference between the purchase price that we pay and the resale price that we receive represents interest paid to us and is included in Other income on our consolidated statements of income (loss). It is our policy to generally take possession of securities purchased under reverse repurchase agreements at the time such agreements are made.

Mortgage-Backed Securities (MBS)

Agency MBS are securities that are obligations (including principal and interest) which are guaranteed by the U.S. government, such as Ginnie Mae, or guaranteed by federally sponsored enterprises, such as Fannie Mae or Freddie Mac, which were placed in the conservatorship of the U.S. government in September 2008. Our investment grade Agency MBS portfolio is invested primarily in fixed-rate and adjustable-rate mortgage-backed

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

pass-through certificates and hybrid adjustable-rate MBS. Hybrid adjustable-rate MBS have an initial interest rate that is fixed for a certain period, usually three to five years, and then adjusts annually for the remainder of the term of the loan. We structure our investment portfolio to be diversified with a variety of prepayment characteristics, investing in mortgage-related assets with prepayment penalties, investing in certain mortgage security structures that have prepayment protections and purchasing mortgage-related assets at a premium and at a discount.

Non-Agency MBS are securities not issued by government-sponsored enterprises which are secured primarily by first-lien residential mortgage loans.

We classify our MBS as either trading investments, available-for-sale investments or held-to-maturity investments. Our management determines the appropriate classification of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. We currently classify all of our MBS as available-for-sale. All assets that are classified as available-for-sale are carried at fair value and unrealized gains or losses are generally included in Other comprehensive income or loss as a component of stockholders' equity. Losses that are credit-related on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from Other comprehensive income to income/(loss).

The most significant source of our revenue is derived from our investments in MBS. Interest income on our Agency MBS and Non-Agency MBS is accrued based on the actual coupon rate and the outstanding principal amount of the underlying mortgages. Premiums and discounts are amortized or accreted into interest income over the lives of the securities using the effective interest yield method, adjusted for the effects of actual prepayments based on the Financial Accounting Standards Board, or FASB, Accounting Standards Codification, or ASC, 320-10. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, street consensus prepayment speeds and current market conditions. If our estimate of prepayments is incorrect, as compared to the aforementioned references, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income, which could be material and adverse.

Securities are recorded on the date the securities are purchased or sold. Realized gains or losses from securities transactions are determined based on the specific identified cost of the securities.

The following table shows our investments' gross unrealized losses and fair value of those individual securities that have been in a continuous unrealized loss position at December 31, 2009 and December 31, 2008, aggregated by investment category and length of time (dollar amounts in thousands):

December 31, 2009

Description of Securities	Less Than 12 Months			12 Months or More (dollar amounts in thousands)			Total		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Agency MBS	48	\$ 895,549	\$ (4,334)	360	\$ 352,040	\$ (7,327)	408	\$ 1,247,589	\$ (11,661)

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2008**

Description of Securities	Less Than 12 Months			12 Months or More (dollar amounts in thousands)			Total		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Agency MBS	82	\$ 1,077,230	\$ (4,984)	388	\$ 538,082	\$ (14,179)	470	\$ 1,615,312	\$ (19,163)

We do not consider those Agency MBS that have been in a continuous loss position for 12 months or more to be other-than-temporarily impaired. The unrealized losses on our investments in Agency MBS were caused by fluctuations in interest rates and recent pricing that is reflective of the liquidity and credit problems surrounding the mortgage markets generally. We purchased the Agency MBS primarily at a premium relative to their face value and the contractual cash flows of those investments are guaranteed by U.S. government or government-sponsored agencies. Since September 2008, the government-sponsored agencies have been in the conservatorship of the U.S. government. We do not expect to sell the Agency MBS at a price less than the amortized cost basis of our investments. Because the decline in market value of the Agency MBS is attributable to changes in interest rates and recent pricing that is reflective of the liquidity and credit problems surrounding the mortgage markets generally and not the credit quality of the Agency MBS in our portfolio, and because we do not have the intent to sell these investments nor is it more likely than not that we will be required to sell these investments before recovery of their amortized cost basis, which may be at maturity, we do not consider these investments to be other-than-temporarily impaired at December 31, 2009.

Repurchase Agreements

We finance the acquisition of our MBS primarily through the use of repurchase agreements. Under these repurchase agreements, we sell securities to a lender and agree to repurchase the same securities in the future for a price that is higher than the original sales price. The difference between the sale price that we receive and the repurchase price that we pay represents interest paid to the lender. Although structured as a sale and repurchase obligation, a repurchase agreement operates as a financing under which we pledge our securities and accrued interest as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. We retain beneficial ownership of the pledged collateral. Upon the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral from the lender or, with the consent of the lender, we may renew such agreement at the then-prevailing financing rate. These repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of the existing pledged collateral declines. We are operating in an environment where, as a result of economic conditions, several large financial institutions involved in repurchase financing of MBS either have been acquired or filed bankruptcy.

Derivative Financial Instruments*Interest Rate Risk Management*

We use primarily short-term (less than or equal to 12 months) repurchase agreements to finance the purchase of our MBS. These obligations expose us to variability in interest payments due to changes in interest rates. We continuously monitor changes in interest rate exposures and evaluate hedging opportunities.

Our objective is to limit the impact of interest rate changes on earnings and cash flows. We achieve this by entering into interest rate swap agreements, which effectively convert a percentage of our repurchase agreements to fixed-rate obligations over a period of up to five years. Under interest rate swap contracts, we agree to pay an

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

amount equal to a specified fixed rate of interest times a notional principal amount and to receive in return an amount equal to a specified variable-rate of interest times a notional amount, generally based on LIBOR. The notional amounts are not exchanged. We account for these swap agreements as cash flow hedges in accordance with ASC 815-10. We do not issue or hold derivative contracts for speculative purposes.

We are exposed to credit losses in the event of non-performance by counterparties to these interest rate swap agreements. In order to limit credit risk associated with swap agreements, our current practice is to only enter into swap agreements with large financial institution counterparties who are market makers for these types of instruments, limit our exposure on each swap agreement to a single counterparty under our defined guidelines and either pay or receive collateral to or from each counterparty on a periodic basis to cover the net fair market value position of the swap agreements held with that counterparty.

Accounting for Derivatives and Hedging Activities

In accordance with ASC 815-10, a derivative that is designated as a hedge is recognized as an asset/liability and measured at estimated fair value. In order for our interest rate swap agreements to qualify for hedge accounting, upon entering into the swap agreement, we must anticipate that the hedge will be highly effective as defined by ASC 815-10.

On the date we enter into a derivative contract, we designate the derivative as a hedge of the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a cash flow hedge). Changes in the fair value of a derivative that are highly effective and that are designated and qualify as a cash flow hedge, to the extent that the hedge is effective, are recorded in Other comprehensive income and reclassified to income when the forecasted transaction affects income (e.g., when periodic settlement interest payments are due on repurchase agreements). The swap agreements are carried on our consolidated balance sheets at their fair value, based on values obtained from large financial institutions who are market makers for these types of instruments. Hedge ineffectiveness, if any, is recorded in current-period income.

We formally assess, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions have been highly effective in offsetting changes in the cash flows of hedged items and whether those derivatives may be expected to remain highly effective in future periods. If it is determined that a derivative is not (or has ceased to be) highly effective as a hedge, we discontinue hedge accounting.

When we discontinue hedge accounting, the gain or loss on the derivative remains in Accumulated other comprehensive income and is reclassified into income when the forecasted transaction affects income. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, we will carry the derivative at its fair value on our balance sheet, recognizing changes in the fair value in current-period income.

For purposes of the cash flow statement, cash flows from derivative instruments are classified with the cash flows from the hedged item.

For more details on the amounts and other qualitative information on our swap agreements, see Note 11. For more information on the fair value of our swap agreements, see Note 5.

Credit Risk

At December 31, 2009, we have attempted to limit our exposure to credit losses on our MBS by purchasing securities primarily through Freddie Mac and Fannie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae MBS are guaranteed by those respective enterprises. In September 2008, both Freddie Mac

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and Fannie Mae were placed in the conservatorship of the U.S. government. While it is hoped that the conservatorship will help stabilize Freddie Mac's and Fannie Mae's losses and overall financial position, there can be no assurance that it will succeed or that, if necessary, Freddie Mac or Fannie Mae will be able to satisfy its guarantees of Agency MBS.

Our adjustable-rate MBS are subject to periodic and lifetime interest rate caps. Periodic caps can limit the amount an interest rate can increase during any given period. Some adjustable-rate MBS subject to periodic payment caps may result in a portion of the interest being deferred and added to the principal outstanding.

Other-than-temporary losses on our available-for-sale MBS, as measured by the amount of decline in estimated fair value attributable to credit losses that are considered to be other-than-temporary, are charged against income, resulting in an adjustment of the cost basis of such securities. Based on the criteria in ASC-320-10, the determination of whether a security is other-than-temporarily impaired (OTTI) involves judgments and assumptions based on both subjective and objective factors. When a security is impaired, an OTTI is considered to have occurred if (i) we intend to sell the security, (ii) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis, or (iii) we do not expect to recover its amortized cost basis (i.e., there is a credit-related loss). The following are among, but not all of, the factors considered in determining whether and to what extent an OTTI exists and the portion that is related to credit loss: (i) the expected cash flow from the investment; (ii) whether there has been an other-than-temporary deterioration of the credit quality of the underlying mortgages; (iii) the credit protection available to the related mortgage pool for MBS; (iv) any other market information available, including analysts' assessments and statements, public statements and filings made by the debtor or counterparty; (v) management's internal analysis of the security, considering all known relevant information at the time of assessment; and (vi) the magnitude and duration of historical decline in market prices. Because management's assessments are based on factual information as well as subjective information available at the time of assessment, the determination as to whether an other-than-temporary decline exists and, if so, the amount considered impaired, is also subjective and therefore constitutes material estimates that are susceptible to significant change.

Income Taxes

We have elected to be taxed as a REIT and to comply with the provisions of the Code with respect thereto. Accordingly, we will not be subject to federal income tax to the extent that our distributions to our stockholders satisfy the REIT requirements and that certain asset, income and stock ownership tests are met.

We have no unrecognized tax benefits and do not anticipate any increase in unrecognized benefits during 2009 relative to any tax positions taken prior to January 1, 2009. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is our policy to record such accruals in our income taxes accounts; and no such accruals existed at December 31, 2009. We file both REIT and taxable REIT subsidiary U.S. federal and California income tax returns. These returns are generally open to examination by the IRS and the California Franchise Tax Board for all years after 2005 and 2004, respectively.

Cumulative Convertible Preferred Stock

We classify our Series B Cumulative Convertible Preferred Stock, or Series B Preferred Stock, on our consolidated balance sheets using the guidance in ASC 480-10-S99. The Series B Preferred Stock contains certain fundamental change provisions that allow the holder to redeem the preferred stock for cash only if certain events occur, such as a change in control. As redemption under these circumstances is not solely within our control, we have classified the Series B Preferred Stock as temporary equity.

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We have analyzed whether the conversion features in the Series B Preferred Stock should be bifurcated under the guidance in ASC 815-10 and have determined that bifurcation is not necessary.

Stock-Based Compensation

In accordance with ASC 718-10, any compensation cost relating to share-based payment transactions is recognized in the consolidated financial statements.

Restricted stock is expensed over the vesting period (see Note 10).

Earnings Per Share

Basic earnings per share, or EPS, is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS assumes the conversion, exercise or issuance of all potential common stock equivalents unless the effect is to reduce a loss or increase the income per share.

The computation of EPS for the years ended December 31, 2009, 2008 and 2007 is as follows (amounts in thousands, except per share data):

	For the Year Ended December 31,		
	2009	2008	2007
Income (loss) from continuing operations	\$ 130,234	\$ 55,049	\$ (5,178)
Loss from discontinued operations			(151,288)
Gain on disposition of discontinued operations		7,558	
Net income (loss)	\$ 130,234	\$ 62,607	\$ (156,466)
Dividend on Series A Cumulative Preferred Stock	(4,044)	(4,044)	(3,033)
Dividend on Series B Cumulative Convertible Preferred Stock	(1,862)	(1,884)	(1,716)
Net income (loss) to common stockholders	\$ 124,328	\$ 56,679	\$ (161,215)
Basic earnings (loss) per common share:			
Continuing operations	\$ 1.18	\$ 0.60	\$ (0.21)
Discontinued operations		0.09	(3.26)
Total basic earnings (loss) per common share	\$ 1.18	\$ 0.69	\$ (3.47)
Diluted (loss) earnings per common share:			
Continuing operations	\$ 1.16	\$ 0.60	\$ (0.21)
Discontinued operations		0.09	(3.26)
Total diluted earnings (loss) per common share	\$ 1.16	\$ 0.69	\$ (3.47)
Basic weighted average number of shares outstanding	105,413	82,043	46,483
Diluted weighted average number of shares outstanding (1)(2)(3)	108,905	85,281	46,483

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- (1) During the year ended December 31, 2007, the number of weighted average shares not included in Diluted EPS because of anti-dilution is 2.9 million.
- (2) During the year ended December 31, 2008, diluted earnings per common share included the assumed conversion of 1.206 million shares of Series B Preferred Stock at the then current conversion rate of 2.6857 shares of common stock and adding back the Series B Preferred Stock dividend.
- (3) During the year ended December 31, 2009, diluted earnings per share included the assumed conversion of 1.108 million shares of Series B Preferred Stock at the then-current conversion rate of 3.1505 shares of our common stock and adding back the Series B Preferred Stock dividends.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accumulated Other Comprehensive Income (Loss)

In accordance with ASC 220-10-55-2, comprehensive income is divided into net income and other comprehensive income (loss), which includes unrealized gains and losses on marketable securities classified as available-for-sale, and unrealized gains and losses on derivative financial instruments that qualify for cash flow hedge accounting under ASC 815-10.

USE OF ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could materially differ from those estimates.

RECENT ACCOUNTING PRONOUNCEMENTS

On June 12, 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets, or SFAS 166, and SFAS No. 167, Amendments to FASB Interpretation No. 46 (R), or SFAS 167. SFAS 166 is a revision to ASC 860-10 and will require more information about transfers of financial assets, including securitization transactions, and also companies having continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets and requires additional disclosures. SFAS 167 is a revision to ASC 810-10 and changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. SFAS 166 and SFAS 167 are effective beginning January 1, 2010. On December 23, 2009, the FASB issued two updates, Accounting Standards Updates, or ASU, No. 2009-16, Transfers and Servicing (Topic 860) Accounting for Transfers of Financial Assets and ASU No. 2009-17, Consolidations (Topic 810) Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities. These two ASUs were issued to incorporate the above June 2009 pronouncements into the accounting standards codification. We are currently evaluating these two new standards and updates but do not believe they will have a material impact on our financial statements.

On June 29, 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, or SFAS 168, and with that authorized the Codification as the new source for authoritative U.S. GAAP (excluding guidance issued by the SEC). The Codification supersedes the existing collection of FASB Statements, Interpretations, Staff Positions, Technical Bulletins, APB (Accounting Principle Board) Opinions, AICPA Statements of Position, EITF consensuses and related literature and reorganizes thousands of U.S. GAAP pronouncements into approximately 90 topics. SFAS 168 is effective for all financial statements issued for reporting periods that end after September 15, 2009. We have adopted SFAS 168 and the Codification did not have a material impact on our financial statements, as it did not change U.S. GAAP, but it changed the references in our financial statements from the individual pronouncements to the appropriate sections in the Codification.

On January 21, 2010, the FASB issued ASU 2010-06, Improving Disclosures about Fair Value Measurements. This ASU amends ASC 820, Fair Value Measurements and Disclosures to add new requirements about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances and settlements relating to Level 3 measurements. It also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure fair value. ASC 820's

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existing guidance requires entities to provide fair value measurement disclosures by major category of assets and liabilities. This ASU requires entities to provide fair value measurements for each class of assets and liabilities. When providing disclosures for equity and debt securities, entities should determine class on the basis of the nature and risks of the securities. In determining the nature and risks of the securities, entities should consider activity or business sector, vintage, geographic concentration, credit quality, and economic characteristics. The ASU requires an entity, in determining the appropriate classes of assets and liabilities to consider the nature and risks of the assets and liabilities as well as their placement in the fair value hierarchy (i.e. Level 1, 2 or 3). This ASU will become effective for our financial statements for the first quarter ending March 31, 2010. We do not believe that this will have a material impact on our financial statements.

NOTE 2. MORTGAGE-BACKED SECURITIES (MBS)

The following tables summarize our Agency MBS and Non-Agency MBS classified as available-for-sale as of December 31, 2009 and December 31, 2008, which are carried at their fair value (amounts in thousands):

December 31, 2009

				Total Agency MBS
Agency MBS (By Agency)	Ginnie Mae	Freddie Mac	Fannie Mae	
Amortized cost	\$ 22,238	\$ 1,294,667	\$ 4,992,868	\$ 6,309,773
Paydowns receivable		10,778		10,778
Unrealized gains	10	46,884	130,017	176,911
Unrealized losses	(302)	(1,881)	(9,478)	(11,661)
Fair value	\$ 21,946	\$ 1,350,448	\$ 5,113,407	\$ 6,485,801

					Total Agency MBS
Agency MBS (By Security Type)	ARMs	Hybrids	Fixed-Rate	Floating- Rate CMOs	
Amortized cost	\$ 1,622,821	\$ 3,875,217	\$ 806,020	\$ 5,715	\$ 6,309,773
Paydowns receivable	2,937	7,841			10,778
Unrealized gains	17,298	118,859	40,754		176,911
Unrealized losses	(8,103)	(3,505)		(53)	(11,661)
Fair value	\$ 1,634,953	\$ 3,998,412	\$ 846,774	\$ 5,662	\$ 6,485,801

	Total Non-Agency MBS
Non-Agency MBS	
Amortized cost	\$ 4,250
Paydowns receivable	
Unrealized gains	492
Unrealized losses	

Fair value	\$ 4,742
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At December 31, 2009, our Non-Agency MBS portfolio consisted of floating-rate CMOs (option-adjusted ARMs based on one-month LIBOR) with an average coupon of 0.48%, which were acquired at par value. Non-Agency MBS are securities not issued by the government or government-sponsored enterprises and are secured primarily by first-lien residential mortgage loans.

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During the year ended December 31, 2009, the fair value of our Non-Agency MBS portfolio declined to approximately \$4.7 million at December 31, 2009 from a fair value of approximately \$7.3 million at December 31, 2008. The detail of this decline is shown on page F-21.

At December 31, 2009, a security representing approximately 33% of the principal balance of our Non-Agency MBS portfolio was rated CCC by Standard & Poor's and a security representing approximately 67% of the principal balance of our Non-Agency MBS portfolio was downgraded from CCC to CC by Standard & Poor's. At December 31, 2009, Moody's Investor Service rated these two securities as Ca.

December 31, 2008

Agency MBS (By Agency)	Ginnie Mae	Freddie Mac	Fannie Mae	Total Agency MBS
Amortized cost	\$ 27,193	\$ 1,283,909	\$ 3,953,192	\$ 5,264,294
Paydowns receivable		5,296		5,296
Unrealized gains		23,900	33,113	57,013
Unrealized losses	(650)	(3,956)	(14,557)	(19,163)
Fair value	\$ 26,543	\$ 1,309,149	\$ 3,971,748	\$ 5,307,440

Agency MBS (By Security Type)	ARMs	Hybrids	Fixed-Rate	Floating-Rate CMOs	Total Agency MBS
Amortized cost	\$ 823,356	\$ 3,407,874	\$ 1,025,071	\$ 7,993	\$ 5,264,294
Paydowns receivable	2,531	2,765			5,296
Unrealized gains	1,089	33,639	22,285		57,013
Unrealized losses	(14,970)	(3,153)	(716)	(324)	(19,163)
Fair value	\$ 812,006	\$ 3,441,125	\$ 1,046,640	\$ 7,669	\$ 5,307,440

Non-Agency MBS	Total Non-Agency MBS
Amortized cost	\$ 44,875
Paydowns receivable	
Unrealized gains	
Unrealized losses, taken in 2008 through earnings as impairment charges	(37,538)
Fair value	\$ 7,337

At December 31, 2008, our Non-Agency MBS portfolio consisted of floating-rate CMOs with an average coupon of 0.72%, which were acquired at par value.

NOTE 3. REPURCHASE AGREEMENTS

We have entered into repurchase agreements with large financial institutions to finance most of our Agency MBS. The repurchase agreements are short-term borrowings that are secured by the market value of our MBS and bear fixed interest rates that have historically been based upon LIBOR. Relative to our Agency MBS portfolio, at December 31, 2009, our repurchase agreements had a weighted average term to maturity of 38 days and a weighted average borrowing rate of 0.24%. After adjusting for swap transactions, the weighted average

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term to the next rate adjustment was 309 days with a weighted average borrowing rate of 1.88%. At December 31, 2009, Agency MBS with a fair value of approximately \$5.75 billion have been pledged as collateral under the repurchase agreements and swap agreements.

One of our former repurchase agreement counterparties, Lehman Brothers, Inc. is in a bankruptcy proceeding and is also under the conservatorship of the Securities Investor Protection Corporation, or the SIPC. As we had pledged securities in connection with our one repurchase agreement outstanding at the time they filed bankruptcy in September 2008 and this agreement was closed out at the direction of the SIPC trustee, we had a receivable of approximately \$1.9 million due us from Lehman Brothers, Inc. We filed a claim with the SIPC for the insurance coverage of up to \$500 thousand and a claim for the full \$1.9 million with the trustee administering the Lehman Brothers, Inc. bankruptcy. Recently, we were informed that our claim with the SIPC for up to \$500 thousand in insurance coverage was dismissed. At this time, we still have the claim in the general bankruptcy proceeding for the full \$1.9 million due us. Although we believe that this claim may be given higher priority because we were a secured counterparty, we believe it appropriate to write-down the amount of this receivable to approximately \$962 thousand, which represents 50% of our original claim, due to the dismissal of the SIPC insurance claim and also due to the general uncertainty regarding the settlement of claims in the Lehman Brothers, Inc. bankruptcy. Depending on the outcome of the settlement of claims in the Lehman Brothers, Inc. bankruptcy case, we may record either more loss or a recovery in future periods. The receivable from Lehman Brothers, Inc. is carried in Other assets on our consolidated balance sheets.

Relative to our Agency MBS portfolio, at December 31, 2008, our repurchase agreements had a weighted average term to maturity of 34 days and a weighted average borrowing rate of 2.07%. After adjusting for swap transactions, the weighted average term to the next rate adjustment was 422 days with a weighted average borrowing rate of 3.25%. At December 31, 2008, Agency MBS with a fair value of approximately \$5.2 billion have been pledged as collateral under the repurchase agreements and swap agreements.

At December 31, 2009 and December 31, 2008, the repurchase agreements had the following balances (in thousands), remaining maturities and weighted average interest rates:

	December 31, 2009		December 31, 2008	
	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate
Overnight	\$		\$	
Less than 30 days	2,427,000	0.24%	2,540,000	2.15%
30 days to 90 days	2,932,000	0.24%	2,005,000	1.78%
Over 90 days to less than 1 year			120,000	5.10%
1 year to 2 years				
Demand				
	\$ 5,359,000	0.24%	\$ 4,665,000	2.07%

NOTE 4. JUNIOR SUBORDINATED NOTES

On March 15, 2005, we issued \$37,380,000 of junior subordinated notes to a newly-formed statutory trust, Anworth Capital Trust I, organized by us under Delaware law. The trust issued \$36,250,000 in trust preferred securities to unrelated third party investors. Both the notes and the trust preferred securities require quarterly payments and bear interest at the prevailing three-month LIBOR rate plus 3.10%, reset quarterly. The first interest payment was made on June 30, 2005. Both the notes and the securities will mature in 2035 and may be

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

redeemable, in whole or in part, without penalty, at our option, after March 30, 2010 and April 30, 2010. We used the net proceeds of this private placement to invest in Agency MBS. We have reviewed the structure of the transaction under ASC 810-10 and concluded that Anworth Capital Trust I does not meet the requirements for consolidation. On September 26, 2005, the notes, the trust preferred securities and the related agreements were amended. The only material change was that one of the class holders requested that interest payments be made quarterly on January 30, April 30, July 30 and October 30 instead of at the end of each calendar quarter. This became effective with the quarterly payment after September 30, 2005.

NOTE 5. FAIR VALUES OF FINANCIAL INSTRUMENTS

As defined in ASC 820-10, fair value is the price that would be received from the sale of an asset or paid to transfer or settle a liability in an orderly transaction between market participants in the principal (or most advantageous) market for the asset or liability. ASC 820-10 establishes a fair value hierarchy that ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value are classified and disclosed in one of the three following categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data. This includes those financial instruments that are valued using models or other valuation methodologies where substantially all of the assumptions are observable in the marketplace, can be derived from observable market data or are supported by observable levels at which transactions are executed in the marketplace. We consider the inputs utilized to fair value our Agency MBS to be Level 2. Management bases the fair value for these investments primarily on third party bid price indications provided by dealers who make markets in these instruments. The Agency MBS market is primarily an over-the-counter market. As such, there are no standard, public market quotations or published trading data for individual MBS securities. As our portfolio consists of hundreds of similar, but distinct, securities that have each been traded with only one broker counterparty, we generally seek to have each Agency MBS security priced by one broker. The prices received are non-binding offers to trade, but are indicative quotations of the market value of our securities as of the market close on the last day of each quarter. The brokers receive trading data from several traders that participate in the active markets for these securities and directly observe numerous trades of securities similar to the securities owned by us. Given the volume of market activity for Agency MBS, it is our belief that the broker pricing accurately reflects market information for actual, contemporaneous transactions. We do not adjust quotes or prices we obtain from brokers and pricing services. In the limited instances where valuations are received on a security from multiple brokers, we use the median value of the prices received to determine fair value. To validate the prices we obtain, to ensure our fair value determinations are consistent with ASC 820, and to ensure that we properly classify these securities in the fair value hierarchy, we evaluate the pricing information we receive taking into account factors such as coupon, prepayment experience, fixed/adjustable rate, coupon index, time to reset and issuing agency, among other factors. Based on these factors, broker prices are compared to prices of similar securities provided by other brokers. If we determine (based on such a comparison and our market knowledge and expertise) that a security is priced significantly differently than similar securities, the broker is contacted and requested to revisit their valuation of the security. If a broker refuses to reconsider its valuation, we will request pricing from another broker and use the median value of the prices received to determine fair value. If we are unable to receive a valuation from another broker, the price received from an independent third party pricing service will be used, if it is determined (based on our market knowledge and expertise) to be more reliable than the broker pricing. However, the fair value reported may not be indicative of the amounts that could be realized in an actual market exchange. Our derivative assets and derivative liabilities are comprised of swap agreements, in which we pay a fixed rate of interest and receive a variable rate of interest that is based on LIBOR. The fair value of these instruments is reported to us independently from dealers who are large financial institutions and are market

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makers for these types of instruments. The LIBOR swap rate is observable at commonly quoted intervals over the full term of the swap agreements and therefore is considered a Level 2 item. The fair value of the derivative instruments' assets and liabilities are the estimated amounts the Company would either receive or pay to terminate these agreements at the reporting date, taking into account current interest rates and the company's credit worthiness. For more information on our swap agreements, see Note 1 and Note 11.

Level 3: Unobservable inputs that are not corroborated by market data. This is comprised of financial instruments whose fair value is estimated based on internally developed models or methodologies utilizing significant inputs that are generally less readily observable from objective sources. At December 31, 2009 and December 31, 2008, we considered the inputs utilized to fair value the Non-Agency MBS to be Level 3. Historically (prior to December 31, 2008), we had received non-binding indications of value from brokers who make markets in Non-Agency MBS and also observe market activity in our Non-Agency MBS as well as other similar securities. As the market for Non-Agency MBS became more volatile and less liquid, we received fewer indications of value on these securities. At December 31, 2009 and December 31, 2008, we were unable to get any brokers who made markets in these securities to provide valuation information on our Non-Agency MBS. Instead, we obtained valuations at December 31, 2009 and December 31, 2008 for our Non-Agency MBS from an experienced independent third party pricing service, whose methodologies are based on broker provided pricing information, as well as indirect observation of market activity. Although we continued to monitor market activity for the Non-Agency MBS in our portfolio, as well as for other similar securities, given the lack of trading activity that we were able to observe, we placed more weight on the third party pricing service valuation as it was both independent and specifically determined. As a result of the lack of valuation information from brokers and our own observation of market activity, we determined that the market for our Non-Agency MBS was inactive. We also believe that the valuations obtained from the independent third party pricing service already take into account the illiquidity of the market for Non-Agency MBS and therefore we do not apply our own liquidity discount when determining their fair value. Based on this information, we consider the fair value measurement of the Non-Agency MBS a Level 3 input at December 31, 2009 and December 31, 2008.

In determining the appropriate levels, the Company performs a detailed analysis of the assets and liabilities that are subject to ASC 820-10. At each reporting period, all assets and liabilities for which the fair value measurement is based on significant unobservable inputs are classified as Level 3.

At December 31, 2009, fair value measurements were as follows (in thousands):

	Level 1	Level 2	Level 3	Total
Assets:				
Agency MBS	\$	\$ 6,485,801	\$	\$ 6,485,801
Non-Agency MBS			4,742	4,742
Derivative instruments(1)		2,059		2,059
Liabilities:				
Derivative instruments(1)	\$	\$ 82,811	\$	\$ 82,811

(1) Derivative instruments are hedging instruments under ASC 815-10.

Cash and cash equivalents, restricted cash, interest receivable, repurchase agreements and interest payable are reflected in our audited consolidated financial statements at their costs, which approximate their fair value because of the nature and short term of these instruments.

Junior subordinated notes are variable-rate debt and, as we believe the spread would be consistent with the expectations of market participants as of December 31, 2009 and December 31, 2008, the carrying value approximates fair value.

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A reconciliation of the Level 3 Non-Agency MBS fair value measurements is as follows (in thousands):

	Amount
Balance at December 31, 2008	\$ 7,337
Principal paydowns	(3,087)
Unrealized gains	492
Balance at December 31, 2009	\$ 4,742

NOTE 6. INCOME TAXES

We have elected to be taxed as a REIT and to comply with the provisions of the Code with respect thereto. Accordingly, we will not be subject to federal or state income taxes to the extent that our distributions to stockholders satisfy the REIT requirements and certain asset, income and stock ownership tests are met. We believe we currently meet all REIT requirements regarding the ownership of our common stock and the distribution of our net income. Therefore, we believe that we continue to qualify as a REIT under the provisions of the Code.

The losses from sales of our MBS in 2007 are capital losses and can only be offset against future capital gains within five years. Belvedere Trust's assets were assigned for the benefit of its creditors to an independent third party in September 2008, such that we were able to write-off for tax purposes as a worthless security our investment of \$100 million in Belvedere Trust. This worthless security write-off would be treated, for tax purposes, as a capital loss and can only be offset against future capital gains within five years. As with all companies, tax positions are subject to tax authority review. Total capital loss carryforwards available to offset future capital gains on our federal REIT return are \$100.4 million. They expire in 2011 and 2012. Income tax expense (benefit) for the years ended December 31, 2009, December 31, 2008 and December 31, 2007 was zero for both continuing operations and discontinued operations. None of the components of income tax expense are significant on a separately stated basis.

Based on the activity of our taxable REIT subsidiaries, which are included in Discontinued operations, a reconciliation of the expected federal income tax expense using the federal statutory tax rate of 34% to actual income tax expense for the years ended December 31 is as follows (dollar amounts in thousands):

	2009	2008	2007
Income tax at statutory rate	\$ 0%	\$ (27) 34.0%	\$ (24) 34.0%
State taxes, net		(5) 5.8%	(4) 5.8%
Valuation allowance		32 (39.8)%	28 (39.8)%
Total income tax expenses	\$ 0%	\$ 0.0%	\$ 0.0%

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Significant components of the deferred tax assets and liabilities at December 31, 2009 and December 31, 2008 were as follows (in thousands):

	2009	2008
Deferred tax assets:		
Prepaid expenses for taxes	\$	\$ 189
Net operating losses		497
Gross deferred tax assets		686
Valuation allowance		(686)
Deferred tax asset		
Deferred tax liabilities:		
General and administrative expenses		
Deferred tax liability		
Net deferred tax asset/liability	\$	\$

The deferred tax assets shown in 2008 relate to our taxable REIT subsidiaries, which are included in Discontinued operations. Prior to 2008, we had already judged it more likely than not that the deferred tax assets would not be utilized in the foreseeable future and had, therefore, recorded a full valuation allowance against them. Due to the September 2008 assignment of Belvedere Trust's assets, we have subsequently written these assets off as unrealizable.

The table below presents tax information regarding Anworth's dividend distributions for the fiscal year ended December 31, 2009:

Series A Cumulative Preferred Stock (CUSIP 03747 20 0)

Declaration Date	Record Date	Payable Date	2009 Total Distribution Per Share	2009 Ordinary Income	2009 Return of Capital	Long-Term Capital Gains
01/28/09	03/31/09	04/15/09	\$ 0.539063	\$ 0.539063	\$	\$
04/13/09	06/30/09	07/15/09	\$ 0.539063	\$ 0.539063	\$	\$
07/10/09	09/30/09	10/15/09	\$ 0.539063	\$ 0.539063	\$	\$
10/10/09	12/31/09	01/15/10	\$ 0.539063	\$ 0.539063	\$	\$

Series B Cumulative Convertible Preferred Stock (CUSIP 03747 30 9)

Declaration Date	Record Date	Payable Date	2009 Total Distribution Per	2009 Ordinary Income	2009 Return of Capital	Long-Term Capital Gains
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			Share			
01/28/09	03/31/09	04/15/09	\$ 0.390625	\$ 0.390625	\$	\$
04/13/09	06/30/09	07/15/09	\$ 0.390625	\$ 0.390625	\$	\$
07/10/09	09/30/09	10/15/09	\$ 0.390625	\$ 0.390625	\$	\$
10/10/09	12/31/09	01/15/10	\$ 0.390625	\$ 0.390625	\$	\$

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Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Common Stock (CUSIP 03747 10 1)**

Declaration Date	Record Date	Payable Date	2009 Total Distribution Per Share	2009 Ordinary Income	2009 Return of Capital	Long-Term Capital Gains
04/13/09	04/30/09	05/19/09	\$ 0.30	\$ 0.300000	\$	\$
07/10/09	07/24/09	08/19/09	\$ 0.32	\$ 0.320000	\$	\$
10/10/09	10/30/09	11/19/09	\$ 0.28	\$ 0.280000	\$	\$
12/16/09	12/28/09	01/19/10	\$ 0.28	\$ 0.280000	\$	\$

NOTE 7. SERIES B CUMULATIVE CONVERTIBLE PREFERRED STOCK

The Series B Preferred Stock has a par value of \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series B Preferred Stock must be paid a dividend at a rate of 6.25% per year on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series B Preferred Stock is senior to the common stock and on parity with our Series A Cumulative Preferred Stock, or Series A Preferred Stock, with respect to the payment of distributions and amounts, upon liquidation, dissolution or winding up.

The Series B Preferred Stock has no maturity date and is not redeemable. Through December 31, 2009, the Series B Preferred Stock was convertible at the then-current conversion rate of 3.1505 shares of our common stock per \$25.00 liquidation preference. The conversion rate will be adjusted in any fiscal quarter in which the cash dividends paid to common stockholders results in an annualized common stock dividend yield that is greater than 6.25%. The conversion ratio will also be subject to adjustment upon the occurrence of certain specific events such as a change of control. The Series B Preferred Stock is convertible into shares of our common stock at the option of the holder(s) of Series B Preferred Stock at any time at the then-prevailing conversion rate. On or after January 25, 2012, we may, at our option, convert under certain circumstances each share of Series B Preferred Stock into a number of common shares at the then-prevailing conversion rate. The Series B Preferred Stock contains certain fundamental change provisions that allow the holder to redeem the Series B Preferred Stock for cash if certain events occur, such as a change in control. The Series B Preferred Stock generally does not have voting rights, except if dividends on the Series B Preferred Stock are in arrears for six or more quarterly periods (whether or not consecutive). Under such circumstances, the holder(s) of Series B Preferred Stock, together with the holders of Series A Preferred Stock, will be entitled to vote to elect two additional directors to our board of directors to serve until all unpaid dividends have been paid or declared and set aside for payment. In addition, certain material and adverse changes to the terms of the Series B Preferred Stock may not be taken without the affirmative vote of at least two-thirds of the outstanding shares of Series B Preferred Stock and Series A Preferred Stock voting together as a single class. Through December 31, 2009, we have declared and set aside for payment the required dividends for the Series B Preferred Stock.

During the year ended December 31, 2009, there were two transactions to convert an aggregate of 6,000 shares of Series B Preferred Stock into an aggregate of 18,020 shares of our common stock (based on the then-current conversion rate of 3.0035; two transaction to convert an aggregate of 112,975 shares of Series B Preferred Stock into an aggregate of 346,862 shares of our common stock (based on the then-current conversion rate of 3.0703); and one transaction to convert an aggregate of 19,436 shares of Series B Preferred Stock into an aggregate of 59,670 shares of our common stock (based on the then-current conversion rate of 3.0703). During the year ended December 31, 2009, we issued approximately 41 thousand shares of Series B Preferred Stock. At December 31, 2009, there were 1.108 million shares of Series B Preferred Stock outstanding.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8. PUBLIC OFFERINGS AND CAPITAL STOCK

At our Annual Meeting of Stockholders held on May 22, 2008, our stockholders approved an amendment to our Amended Articles of Incorporation to increase our authorized number of shares of common stock from 100 million to 200 million shares. At December 31, 2009, 115,563,004 shares of our common stock were issued and outstanding.

At December 31, 2009, our authorized capital included 20 million shares of \$0.01 par value preferred stock, of which 5.15 million shares had been designated 8.625% Series A Cumulative Preferred Stock (liquidation preference \$25.00 per share) and 3.15 million shares had been designated 6.25% Series B Cumulative Convertible Preferred Stock (liquidation preference \$25.00 per share). The undesignated shares of preferred stock may be issued in one or more classes or series, with such distinctive designations, rights and preferences as determined by our board of directors.

On February 9, 2009, we issued 8 million shares of common stock in a secondary public offering and received net proceeds of approximately \$46 million (net of underwriting fees, commissions and other costs). We used all of the net proceeds from this offering to acquire Agency MBS.

On May 14, 2008, we entered into a new Controlled Equity Offering Sales Agreement, or the 2008 Sales Agreement, with Cantor Fitzgerald & Co., or Cantor. Under the Controlled Equity Offering Program, or the Program, we may sell, from time to time, in our sole discretion, up to 15 million shares of common stock, 1.25 million shares of Series A Preferred Stock and 2 million shares of Series B Preferred Stock. During the year ended December 31, 2009, we sold 6.736 million shares of our common stock under the Program, which provided net proceeds to us of approximately \$48.8 million, net of sales commissions less reimbursement of fees and also net of other costs. The sales agent received an aggregate of approximately \$998 thousand, which represents an average commission of approximately 2.0% on the gross sales price per share. During the year ended December 31, 2009, we sold 41.2 thousand shares of our Series B Preferred Stock under the Program, which provided net proceeds to us of approximately \$1 million, net of sales commissions less reimbursement of fees. The sales agent received an aggregate of approximately \$20.5 thousand, which represents an average commission of approximately 2.0% on the gross sales price per share. At December 31, 2009, there were 5,101,900 shares of common stock, 1,225,000 shares of Series A Preferred Stock and 1,902,800 shares of Series B Preferred Stock, respectively, available under the 2008 Sales Agreement.

Our Dividend Reinvestment and Stock Purchase Plan allow stockholders and non-stockholders to purchase shares of our common stock and to reinvest dividends therefrom to acquire additional shares of our common stock. On April 11, 2008, we filed a shelf registration statement on Form S-3 with the SEC to register 15 million shares of common stock for our 2008 Dividend Reinvestment and Stock Purchase Plan, or the 2008 Plan. During the year ended December 31, 2009, we issued approximately 9.75 million shares of common stock under the 2008 Plan, resulting in proceeds to us of approximately \$65.8 million. On December 28, 2009, we filed a shelf registration statement on Form S-3ASR with the SEC, offering up to 20 million shares of our common stock for our 2009 Dividend Reinvestment and Stock Purchase Plan, or the 2009 Plan. The registration statement was declared effective on December 28, 2009. At December 31, 2009, there were approximately 20 million shares remaining under the 2009 Plan.

On May 23, 2007, we filed a shelf registration statement on Form S-3 with the SEC, offering up to \$500 million of our capital stock. The registration statement was declared effective on June 8, 2007. At December 31, 2009, approximately \$82.8 million of this amount remained available for issuance under the registration statement.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On December 28, 2009, we filed a shelf registration statement on Form S-3 with the SEC, offering up to \$600 million of our capital stock. We plan to request acceleration of effectiveness on February 26, 2010 and expect the SEC will declare the shelf registration statement effective on or about February 26, 2010.

On November 7, 2005, we filed a registration statement on Form S-8 with the SEC to register an aggregate of up to 3.5 million shares of our common stock to be issued pursuant to the Anworth Mortgage Asset Corporation 2004 Equity Compensation Plan. To date, we have issued 2.778 million shares under the plan. This amount includes 1.278 million shares of unexercised stock options, restricted stock and phantom shares.

NOTE 9. TRANSACTIONS WITH AFFILIATES

Anworth 2002 Incentive Compensation Plan

Under our 2002 Incentive Compensation Plan, or the 2002 Incentive Plan, Lloyd McAdams, our Chief Executive Officer, Joseph E. McAdams, our Chief Investment Officer, Heather U. Baines, our Executive Vice President, and other executives have the opportunity to earn incentive compensation during each fiscal quarter. The 2002 Incentive Plan requires that we pay all amounts earned thereunder each quarter (subject to offset for accrued negative incentive compensation) and we will be required to pay a percentage of such amounts to certain of our executives pursuant to the terms of their employment agreements. Pursuant to their employment agreements, Lloyd McAdams, Joseph E. McAdams and Heather U. Baines are entitled to minimum percentages of all amounts paid under the 2002 Incentive Plan. Those percentages are 45%, 25% and 5%, respectively. The 2002 Incentive Plan is tied directly to our performance and is designed to incentivize key employees to maximize return on equity. The total aggregate amount of compensation that may be earned quarterly by all participants under the plan equals a percentage of net income, before incentive compensation, in excess of the amount that would produce an annualized return on average net worth equal to the ten-year U.S. Treasury Rate plus 1%, or the Threshold Return. At December 31, 2009, the Threshold Return was 4.44%.

Average net worth, as defined in the 2002 Incentive Plan which was amended by our Compensation Committee on August 3, 2009 and approved by our board of directors on October 8, 2009 (and which amendment was filed with the SEC on October 15, 2009 as an exhibit to a Current Report on Form 8-K), for any period is (i) the daily average of the cumulative net proceeds to date from all offerings of the Company's equity securities, after deducting any underwriting discounts and commissions and other expenses and costs related to such offerings, plus (ii) the Company's retained earnings computed by taking the average of such values at the end of each month during such period.

The 2002 Incentive Plan contains a high water-mark provision requiring that in any fiscal quarter in which net income is an amount less than the amount necessary to earn the Threshold Return, the Company will calculate negative incentive compensation for that fiscal quarter which will be carried forward and will offset future incentive compensation earned under the 2002 Incentive Plan with respect to participants who were participants during the fiscal quarter(s) in which negative incentive compensation was generated. At December 31, 2009, the incentive compensation accrual carry forward was a negative \$12.2 million, which was reduced from a negative \$19.1 million at December 31, 2008. This negative carry forward may provide an incentive to management to make higher risk investments in an attempt to generate returns to overcome the negative carry forward.

The percentage of taxable net income in excess of the Threshold Return earned under the 2002 Incentive Plan by all employees is calculated based on our quarterly average net worth as defined in the 2002 Incentive Plan. The percentage rate used in this calculation is based on a blended average of the following tiered percentage rates:

25% for the first \$50 million of average net worth;

15% for the average net worth between \$50 million and \$100 million;

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10% for the average net worth between \$100 million and \$200 million; and

5% for the average net worth in excess of \$200 million.

During the years ended December 31, 2009 and December 31, 2008, eligible employees under the 2002 Incentive Plan did not earn any incentive compensation due to the negative incentive carry forward under the Plan.

Employment Agreements

Salary, Incentive and Termination Provisions

Pursuant to the terms of their employment agreements with us, Lloyd McAdams serves as our President, Chairman and Chief Executive Officer, Joseph E. McAdams serves as our Executive Vice President and Chief Investment Officer, and Heather U. Baines serves as our Executive Vice President. Lloyd McAdams receives a \$925 thousand annual base salary, Joseph E. McAdams receives a \$700 thousand annual base salary and Heather U. Baines receives a \$60 thousand annual base salary.

These employment agreements also have the following provisions:

the three executives are entitled to participate in the 2002 Incentive Plan and each of these individuals are provided a minimum percentage of the amounts earned under such plan. Lloyd McAdams is entitled to 45% of all amounts paid under the plan, Joseph E. McAdams is entitled to 25% of all amounts paid under the plan and Heather U. Baines is entitled to 5% of all amounts paid under the plan.

the 2002 Incentive Plan may not be amended without the consent of Lloyd McAdams and Joseph E. McAdams;

in the event any of the three executives is terminated without cause, or if they terminate for good reason, or, in the case of Lloyd McAdams or Joseph E. McAdams, their employment agreements are not renewed, then the executives would be entitled to: (1) all base salary due under the employment agreements, (2) all discretionary bonus due under their employment agreements, (3) a lump sum payment of an amount equal to three years of the executive's then-current base salary, (4) payment of COBRA medical coverage for 18 months, (5) immediate vesting of all pension benefits, (6) all incentive compensation to which the executives would have been entitled to under the employment agreements prorated through the termination date, and (7) all expense reimbursements and benefits due and owing the executives through the termination. In addition, under these circumstances Lloyd McAdams and Joseph E. McAdams would each be entitled to a lump sum payment equal to 150% of the greater of (i) the highest amount paid or that could be payable (in the aggregate) under the 2002 Incentive Plan during any one of the three fiscal years prior to their termination, and (ii) the highest amount paid, or that could be payable (in the aggregate), under the 2002 Incentive Plan during any of the three fiscal years following their termination. Ms. Baines would also be entitled to a lump sum payment equal to all incentive compensation that Ms. Baines would have been entitled to under the 2002 Incentive Plan during the three-year period following her termination;

the equity awards granted to each of the three executives will immediately vest upon the termination of the executive's employment if such termination is in connection with a change in control;

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Lloyd McAdams and Joseph E. McAdams are each subject to a one-year non-competition provision following termination of their employment except in the event of a change in control; and

each agreement contains an evergreen provision that permits automatic renewal for one year at the end of each term unless written notice of termination is provided by either party six months prior to the end of the current term.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Performance-Based Bonus Pool Provisions

Under the terms of their employment agreements, a long-term equity incentive structure was established for Messrs. Lloyd McAdams and Joseph E. McAdams. As a result, they are eligible to participate in a performance-based bonus pool that is funded based on the Company's return on average equity, or ROAE. ROAE is calculated as the twelve-month net income available to common stockholders, excluding the effect of depreciation, preferred stock dividends, gains/losses on asset sales and impairment charges, divided by the average stockholder equity less goodwill and preferred stockholder equity. The Compensation Committee of our board of directors, or the Compensation Committee, evaluated various measures and factors of performance in developing this structure and, in its view, ROAE was determined to be the single best indicator of our overall performance and therefore of value creation for our stockholders. This is in part due to the fact that ROAE is a metric of our performance that has been calculated and reported on a consistent basis since our inception in 1998.

As structured by the Compensation Committee, the aggregate amount of this performance-based bonus pool available for distribution can range annually based upon our ROAE in accordance with the following:

if our ROAE is 0% or less, no performance-based bonus is paid.

if our ROAE is greater than 0% but less than 8%, a bonus pool of up to \$500 thousand is available in the aggregate.

if our ROAE is 8% or greater, then the bonus pool available to be paid to both executives in the aggregate equals \$500 thousand plus 10% of the first \$5 million of excess return and 6% of the amount of the excess return greater than \$5 million.

The Compensation Committee has the discretionary right to adjust downward the amount available for distribution from the bonus pool by as much as 10% in any given year, based upon its assessment of factors including our leverage, stability of the book value of our common stock and price per share of our common stock relative to other industry participants. Of the aggregate amount available for distribution from the bonus pool, the Compensation Committee bases annual bonus allocation to each of Messrs. Lloyd McAdams and Joseph E. McAdams on its assessment of the performance of each executive.

In order to further align the performance of Messrs. Lloyd McAdams and Joseph E. McAdams with our long-term financial success and the creation of stockholder value, the Compensation Committee also determined that with respect to 2008 and each year thereafter, 25% of the annual performance-based bonus amount allocated to be distributed to an executive over \$100 thousand would be paid in restricted shares of common stock (the "Restricted Shares"). In addition, neither executive will be permitted to sell or otherwise transfer any Restricted Shares during the executive's employment with us until the value of his respective stock holdings in the company exceeds a seven and one-half times multiple of his base compensation and, once this threshold is met, only to the extent that the value of such holdings exceeds that multiple. For the year ended December 31, 2009, the Compensation Committee approved, and the Company issued, an aggregate of 187,247 shares of common stock at a volume weighted average price of \$7.0223 to Messrs. Lloyd McAdams and Joseph E. McAdams in accordance with the terms of their employment agreements. The total incentive compensation paid to these executives for the years ended December 31, 2009 and December 31, 2008 (including the stock issuance) was approximately \$5.26 million and \$3.8 million, respectively (not including the discretionary incentive compensation as shown below).

Prior to the end of any year, the Compensation Committee, at its discretion, may notify an executive that the executive will not participate in the pool during the following year. If this occurs, the sale or transfer restrictions on previously issued pool shares will be eliminated at that time.

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The Compensation Committee, in its discretion, may provide additional compensation to each of Messrs. Lloyd McAdams and Joseph E. McAdams beyond the annual performance-based bonus awards earned under the incentive compensation structure in their employment agreements. This additional compensation may be provided in consideration of the Company's execution of our business and strategic plans. During the years ended December 31, 2009 and December 31, 2008, we paid these executives additional compensation of approximately \$1.25 million and \$1.4 million, respectively.

Change in Control and Arbitration Agreements

On June 27, 2006, we entered into Change in Control and Arbitration Agreements with each of Thad M. Brown, our Chief Financial Officer, Charles J. Siegel, our Senior Vice President-Finance, Bistra Pashamova, our Senior Vice President and Portfolio Manager, and Evangelos Karagiannis, our Vice President and Portfolio Manager, as well as certain of our other employees. The Change in Control and Arbitration Agreements grant these officers and employees, in the event that a change in control occurs (as defined therein), a lump sum payment equal to (i) 12 months annual base salary in effect on the date of the change in control, plus (ii) the average annual incentive compensation received for the two complete fiscal years prior to the date of the change in control, and plus (iii) the average annual bonus received for the two complete fiscal years prior to the date of the change in control, as well as other benefits. The Change in Control and Arbitration Agreements also provide for accelerated vesting of equity awards granted to these officers and employees upon a change in control.

Agreements with Pacific Income Advisers, Inc.

On June 13, 2002, we entered into a sublease with Pacific Income Advisers, Inc., or PIA, a company owned by trusts controlled by certain of our officers. Under the sublease, as amended on July 8, 2003, we lease, on a pass-through basis, 5,500 square feet of office space from PIA and pay rent at an annual rate equal to PIA's obligation, currently \$54.16 per square foot. The sublease runs through June 30, 2012 unless earlier terminated pursuant to the master lease. During the year ended December 31, 2009, we paid \$331 thousand in rent and other operating expenses to PIA under the sublease, which is included in Other expenses on the consolidated statements of income. During the years ended December 31, 2008 and 2007, we paid \$337 thousand and \$277 thousand, respectively, in rent and related expenses to PIA under this sublease.

At December 31, 2009, the future minimum lease commitment was as follows (in whole dollars):

Year	2010	2011	2012	Total Commitment
Commitment	\$ 302,332	\$ 311,414	\$ 158,012	\$ 771,758

On October 14, 2002, we entered into an administrative services agreement with PIA. On July 25, 2008, we entered into a new administrative services agreement with PIA which was amended on December 29, 2008. Under the administrative services agreement, PIA provides administrative services and equipment to us including human resources, operational support and information technology, and we pay an annual fee of 7 basis points on the first \$225 million of stockholders' equity, 5 basis points on the next \$450 million of stockholders' equity and 3.5 basis points thereafter (paid quarterly in arrears) for those services. The administrative services agreement is for an initial term of one year and will renew for successive one-year terms thereafter unless either party gives notice of termination no less than 30 days before the expiration of the then-current annual term. We may also terminate the administrative services agreement upon 30 days prior written notice for any reason and immediately if there is a material breach by PIA. Included in Other expenses on the consolidated statements of income are fees of \$298 thousand paid to PIA in connection with this agreement during the year ended December 31, 2009. During the years ended December 31, 2008 and 2007, we paid fees of \$345 thousand and \$250 thousand, respectively, to PIA in connection with this agreement.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred Compensation Plan

On January 15, 2003, we adopted the Anworth Mortgage Asset Corporation Deferred Compensation Plan, or the Deferred Compensation Plan. We amended the plan effective January 1, 2005 to comply with Section 409A of the Code enacted as part of the American Jobs Creation Act of 2004. The Deferred Compensation Plan permits our eligible officers to defer the payment of all or a portion of their cash compensation that otherwise would be in excess of the \$1 million annual limitation on deductible compensation imposed by Section 162(m) of the Code (based on the officers' compensation and benefit elections made prior to January 1 of the calendar year in which the compensation will be deferred). Under this limitation, compensation paid to our Chief Executive Officer and our four other highest paid officers is not deductible by us for income tax purposes to the extent the amount paid to any such officer exceeds \$1 million in any calendar year, unless such compensation qualifies as performance-based compensation under Section 162(m). Our board of directors designates the eligible officers who may participate in the Deferred Compensation Plan from among the group consisting of our Chief Executive Officer and our other four highest paid officers. To date, the board has designated all of the executive officers as those who may participate in the Deferred Compensation Plan. Each eligible officer becomes a participant in the Deferred Compensation Plan by making a written election to defer the payment of cash compensation. With certain limited exceptions, the election must be filed with us before January 1 of the calendar year in which the compensation will be deferred. The election is effective for the entire calendar year and may not be terminated or modified for that calendar year. If a participant wishes to defer compensation in a subsequent calendar year, a new deferral election must be made before January 1 of that subsequent year.

Amounts deferred under the Deferred Compensation Plan are not paid to the participant as earned, but are credited to a bookkeeping account maintained by us in the name of the participant. The balance in the participant's account is credited with earnings at a rate of return equal to the annual dividend yield on our common stock. The balance in the participant's account is paid to the participant six months after termination of employment or upon the death of the participant or a change in control of our company. Each participant is a general unsecured creditor of our company with respect to all amounts deferred under the Deferred Compensation Plan. For the year ended December 31, 2009, none of the participants of the Deferred Compensation Plan elected to defer any compensation. At December 31, 2009, the aggregate balance of the amounts previously deferred for Lloyd McAdams was \$364,874.

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At our May 27, 2004 annual stockholders meeting, our stockholders adopted the Anworth Mortgage Asset Corporation 2004 Equity Compensation Plan, or the Plan, which amended and restated our 1997 Stock Option and Awards Plan. The Plan authorized the grant of stock options and other stock-based awards, as of December 31, 2005, for an aggregate of up to 3,500,000 of the outstanding shares of our common stock. The Plan authorizes our board of directors, or a committee of our Board, to grant incentive stock options, as defined under section 422 of the Code, options not so qualified, restricted stock, dividend equivalent rights (DERs), phantom shares, stock-based awards that qualify as performance-based awards under Section 162(m) of the Code and other stock-based awards. The exercise price for any option granted under the Plan may not be less than 100% of the fair market value of the shares of common stock at the time the option is granted. At December 31, 2009, 721,616 shares remained available for future issuance under the Plan through any combination of stock options or other awards. The Plan does not provide for automatic annual increases in the aggregate share reserve or the number of shares remaining available for grant. We filed a registration statement on Form S-8 on November 7, 2005 to register an aggregate of up to 3,500,000 shares of our common stock to be issued pursuant to the Plan.

A summary of stock option transactions for the plan follows:

	2009		2008		2007	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	1,184,969	\$ 12.397	1,360,930	\$ 12.123	1,360,930	\$ 12.123
Granted						
Exercised	(2,644)	4.35	(53,961)	6.07		
Expired	(342,000)	12.47	(122,000)	12.13		
Outstanding, end of year	840,325	\$ 12.392	1,184,969	\$ 12.397	1,360,930	\$ 12.123

Weighted average fair value of options expired during the year	\$ 12.47	\$ 12.13	\$
Options exercisable at year-end	840,325	1,184,969	1,360,930
The aggregate intrinsic value of options exercised during 2009 and 2008 and those outstanding at December 31, 2009 and December 31, 2008 are immaterial.			

The following table summarizes information about stock options outstanding at December 31, 2009:

Options			
Exercise Price	Outstanding and	Remaining	
	Exercisable at	Contractual	
	December 31, 2009	Life (Years)	
\$ 6.70	520	1.6	
\$ 7.10	6,000	1.6	
\$ 9.45	127,505	2.1	
\$11.20	264,000	2.8	

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\$11.25	10,000	2.8
\$13.80	427,300	3.3
\$ 9.72	5,000	5.6
	840,325	

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The following table summarizes information about restricted stock outstanding at December 31, 2009:

Grant Date Fair Value	Unvested Shares at December 31, 2008	Restricted Shares Granted	Shares Vested in 2009	Shares Forfeited	Unvested Shares at December 31, 2009	Weighted Average Remaining Contractual Life (Years)
\$4.24	126,954		18,132		108,822	5.8
\$5.93	197,362				197,362	6.8
	324,316		18,132		306,184	6.4

In October 2005, our board of directors approved the grant of 200,780 shares of restricted stock to various of our employees under our 2004 Equity Plan. The stock price on the grant date was \$7.72. The restricted stock vests 10% per year on each anniversary date for a ten-year period and shall also vest immediately upon the death of the grantee or upon the grantee reaching age 65. Each grantee shall have the right to sell 40% of the restricted stock anytime after such shares have vested. The remaining 60% of such vested restricted stock may not be sold until after termination of employment with us. We amortize the restricted stock over the vesting period, which is the lesser of ten years or the remaining number of years to age 65.

In October 2006, our board of directors approved a grant of an aggregate of 197,362 shares of performance-based restricted stock to various of our officers and employees under our 2004 Equity Plan. Such grant was made effective on October 18, 2006. The closing stock price on the effective date of the grant was \$9.12. The shares will vest in equal annual installments over the next three years provided that the annually compounded rate of return on our common stock, including dividends, exceeds 12% measured from the effective date of the grant to each of the next three anniversary dates. If the annually compounded rate of return does not exceed 12%, then the shares will vest on the anniversary date thereafter when the annually compounded rate of return exceeds 12%. If the annually compounded rate of return does not exceed 12% within ten years after the effective date of the grant, then the shares will be forfeited. The shares will fully vest within the ten-year period upon the death of a grantee. Upon vesting, each grantee shall have the right to sell 40% of the restricted stock anytime after such shares have vested. The remaining 60% of such vested restricted stock may not be sold, transferred or pledged until after termination of employment with us or upon the tenth anniversary of the effective date.

The fair value of the aforementioned stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions:

	2005 Grant	2006 Grant
Assumptions:		
Dividend yield	6.00%	4.00%
Expected volatility	29.00%	28.00%
Risk-free interest rate	4.29%	4.80%
Expected lives	10 years	10 years

We recognize the compensation expense related to restricted stock over the ten-year vesting period. The weighted average remaining term of the two grants is 6.4 years and the remaining amount to be recognized is approximately \$1.3 million. During the years ended December 31, 2009 and December 31, 2008, we expensed approximately \$202 thousand and \$202 thousand, respectively, related to these restricted stock grants.

At our May 24, 2007 annual meeting of stockholders, our stockholders adopted the Anworth Mortgage Asset Corporation 2007 Dividend Equivalent Rights Plan, or the 2007 Dividend Equivalent Rights Plan. A

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Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

dividend equivalent right, or DER, is a right to receive amounts equal in value to the dividend distributions paid on a share of our common stock. DERs are paid in either cash or shares of our common stock, whichever is specified by our Compensation Committee at the time of grant, at such times as dividends are paid on shares of our common stock during the period between the date a DER is issued and the date the DER expires or earlier terminates. The committee may impose such other conditions to the grant of DERs as it may deem appropriate. The maximum term for DERs under the 2007 Dividend Equivalent Rights Plan is ten years from the date of grant. There were no awards of DERs granted during 2007. On February 22, 2008, a grant of an aggregate of 300 thousand DERs under the DER Plan was issued to our employees and officers. On December 22, 2008, a grant of an aggregate of 150 thousand DERs under the DER Plan was issued to our employees and officers. On December 16, 2009, a grant of an aggregate of 50 thousand DERs under the DER Plan was issued to our employees and officers. These DERs are not attached to any stock and only have the right to receive the same cash distribution per common share distributed to our common stockholders during the term of the grant. All of these grants have a five-year term from the date of the grant. During the years ended December 31, 2009 and December 31, 2008, we paid or accrued \$545 thousand and \$339 thousand, respectively, as compensation related to these grants.

NOTE 11. HEDGING INSTRUMENTS

At December 31, 2009, we were a counterparty to interest rate swap agreements, which are derivative instruments as defined by ASC 815-10, with an aggregate notional amount of \$2.32 billion and a weighted average maturity of 1.9 years. These swap agreements were with the following six counterparties: (1) Deutsche Bank Securities notional amount: \$825 million; (2) Credit Suisse First Boston Corporation notional amount: \$695 million; (3) Citigroup notional amount: \$400 million; (4) J.P. Morgan Securities Inc. notional amount: \$100 million; (5) LBBW Securities, LLC notional amount: \$50 million; and (6) Nomura Securities International, Inc. notional amount: \$250 million. During the year ended December 31, 2009, nine swap agreements with an aggregate notional amount of \$760 million matured. During the year ended December 31, 2009, we entered into five new swap agreements with an aggregate notional amount of \$400 million and terms of up to five years. We utilize swap agreements to manage interest rate risk relating to our repurchase agreements (the hedged item) and do not anticipate entering into derivative transactions for speculative or trading purposes. In accordance with the swap agreements, we will pay a fixed-rate of interest during the term of the swap agreements (ranging from 1.788% to 5.7375%) and receive a payment that varies with the three-month LIBOR rate.

At December 31, 2009 and December 31, 2008, our swap agreements had the following notional amounts (in thousands) and weighted average interest rates:

	December 31, 2009		December 31, 2008	
	Notional Amount	Weighted Average Interest Rate	Notional Amount	Weighted Average Interest Rate
Less than 12 months	\$ 750,000	4.75%	\$ 760,000	4.20%
1 year to 2 years	475,000	4.36%	750,000	4.75%
2 years to 3 years	520,000	3.92%	475,000	4.36%
3 years to 4 years	375,000	3.32%	420,000	4.43%
4 years to 5 years	200,000	2.43%	275,000	3.77%
	\$ 2,320,000	4.06%	\$ 2,680,000	4.37%

For the year ended December 31, 2009, there was a decrease in unrealized losses of \$58.3 million, from \$139.8 million in unrealized losses at December 31, 2008 to \$81.5 million in unrealized losses, on our swap agreements included in Other comprehensive income (this decrease consisted of unrealized losses on cash flow hedges of \$24.1 million and a reclassification adjustment for interest expense included in net income of \$82.4 million).

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2009, we had asset derivatives of \$2.1 million and liability derivatives (both shown on our audited consolidated balance sheets) of \$82.8 million.

During the year ended December 31, 2009, there was a gain of \$107 thousand recognized in earnings due to hedge ineffectiveness. We have determined that our hedges are still considered highly effective. There were no components of the derivative instruments gain or loss excluded from the assessment of hedge effectiveness. The maximum length of our swap agreements is five years. We do not anticipate any discontinuance of the swap agreements and thus do not expect to recognize any gain or loss into earnings because of this. On September 18, 2008, we terminated all of our interest rate swap agreements with Lehman Brothers Special Finance, or LBSF, as the counterparty. The notional balance of these swap agreements was \$240 million. The fair value of these swap agreements at termination was approximately \$(1.5) million, reflecting a realized loss. This loss is being amortized into interest expense over the remaining term of the related hedged borrowings. During the year ended December 31, 2009, the amount amortized into interest expense was approximately \$574 thousand and the remaining amount at December 31, 2009 to be amortized was approximately \$763 thousand.

For more information on our accounting policies, the objectives and risk exposures relating to derivatives and hedging agreements, see the section on Derivative Financial Instruments in Note 1. For more information on the fair value of our swap agreements, see Note 5.

NOTE 12. COMMITMENTS AND CONTINGENCIES

- (a) Lease Commitment and Administrative Services Commitment We sublease office space and use administrative services from PIA, as more fully described in Note 9.

NOTE 13. OTHER EXPENSES

	Year Ended December 31,		
	2009	2008	2007
	(in thousands)		
Legal and accounting fees	\$ 710	\$ 608	\$ 715
Printing and stockholder communications	124	117	115
Directors and Officers insurance	457	536	374
Software and implementation and maintenance	228	231	222
Administrative service fees	298	345	250
Rent	331	337	277
Stock exchange and filing fees	201	278	157
Custodian fees	163	159	127
Sarbanes-Oxley consulting fees	108	102	151
Board of directors fees and expenses	303	337	419
Securities data services	107	105	117
Other	335	283	266
Total of other expenses:	\$ 3,365	\$ 3,438	\$ 3,190

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTE 14. SUMMARIZED QUARTERLY RESULTS (UNAUDITED)**

The following tables summarize quarterly results for the years ended December 31, 2009 and December 31, 2008. Earnings per share amounts for each quarter and the full years have been calculated separately. Accordingly, quarterly amounts may not add to the annual amounts because of substantial differences in the average shares outstanding during each period and, with regard to diluted earnings per share amounts, they may also differ because of the inclusion of the effect of potentially dilutive securities only in the periods in which such effect would have been dilutive.

For the year ended December 31, 2009 (in thousands, except per share amounts):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Interest income net of amortization of premium and discount:				
Interest on Agency MBS	\$ 66,895	\$ 67,111	\$ 63,150	\$ 64,469
Interest on Non-Agency MBS	75	72	57	51
Other income	46	67	27	9
	67,016	67,250	63,234	64,529
Interest expense:				
Interest expense on repurchase agreements	32,038	28,796	27,573	25,751
Interest expense on junior subordinated notes	455	402	357	335
	32,493	29,198	27,930	26,086
Net interest income	34,523	38,052	35,304	38,443
Gain on derivative instruments	107			
Write-down of Lehman receivable				(962)
Expenses	(3,889)	(4,022)	(3,611)	(3,711)
Net income	30,741	34,030	31,693	33,770
Dividend on Series A Cumulative Preferred Stock	(1,011)	(1,011)	(1,011)	(1,011)
Dividend on Series B Cumulative Convertible Preferred Stock	(471)	(471)	(487)	(433)
Net income to common stockholders	\$ 29,259	\$ 32,548	\$ 30,195	\$ 32,326
Basic earnings per common share	\$ 0.30	\$ 0.32	\$ 0.28	\$ 0.28
Diluted earnings per common share(1)	\$ 0.30	\$ 0.31	\$ 0.27	\$ 0.28
Basic weighted average number of shares outstanding	95,974	102,344	109,125	113,970
Diluted weighted average number of shares outstanding	99,333	105,849	112,868	117,462

- (1) During the year ended December 31, 2009, diluted earnings per common share include the assumed conversion of 1.206 million shares of Series B Preferred Stock at March 31, 2009 and June 30, 2009, 1.246 million shares at September 30, 2009; and 1.108 million shares at December 31, 2009 at each quarter-end conversion rate and adding back the Series B Preferred Stock dividend. At March 31, 2009, June 30, 2009, September 30, 2009 and December 31, 2009, the conversion rate was 2.7865, 2.9075, 3.0035 and 3.1505, respectively.

Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For the year ended December 31, 2008 (in thousands, except per share amounts):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Interest income net of amortization of premium and discount:				
Interest on Agency MBS	\$ 67,579	\$ 73,872	\$ 73,194	\$ 71,043
Interest on Non-Agency MBS	420	320	320	248
Other income	402	125	126	49
	68,401	74,317	73,640	71,340
Interest expense:				
Interest expense on repurchase agreements	48,395	44,976	43,846	41,657
Interest expense on junior subordinated notes	695	566	564	623
	49,090	45,542	44,410	42,280
Net interest income	19,311	28,775	29,230	29,060
(Loss) gain on sale of Agency MBS and Non-Agency MBS and derivatives	(280)	273	(990)	834
Impairment charges on Non-Agency MBS			(34,083)	(3,455)
Expenses	(2,466)	(3,324)	(3,176)	(4,660)
Income (loss) income from continuing operations	16,565	25,724	(9,019)	21,779
Income from discontinued operations	12	78		
Gain (loss) on disposition of discontinued operations			7,728	(170)
Net income (loss)	16,577	25,802	(1,291)	21,609
Dividend on Series A Cumulative Preferred Stock	(1,011)	(1,011)	(1,011)	(1,011)
Dividend on Series B Cumulative Convertible Preferred Stock	(471)	(471)	(471)	(471)
Net income (loss) to common stockholders	\$ 15,095	\$ 24,320	\$ (2,773)	\$ 20,127
Basic earnings (loss) per common share:				
Continuing operations	\$ 0.22	\$ 0.30	\$ (0.12)	\$ 0.22
Discontinued operations			0.09	
Total basic earnings (loss) per common share	\$ 0.22	\$ 0.30	\$ (0.03)	\$ 0.22
Diluted earnings (loss) per common share(1):				
Continuing operations	\$ 0.21	\$ 0.29	\$ (0.12)	\$ 0.22
Discontinued operations			0.09	
Total diluted (loss) earnings per common share	\$ 0.21	\$ 0.29	\$ (0.03)	\$ 0.22
Basic weighted average number of shares outstanding	69,708	82,191	86,381	89,759

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Diluted weighted average number of shares outstanding	72,581	85,125	86,381	92,997
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- (1) During the year ended December 31, 2008, diluted earnings per common share include the assumed conversion of 1.206 million shares of Series B Preferred Stock at each quarter-end conversion rate and adding back the Series B Preferred Stock dividend. At March 31, 2008, June 30, 2008, September 30, 2008 and December 31, 2008, the conversion rate was 2.3809, 2.4318, 2.5464 and 2.6857, respectively.

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Table of Contents**ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTE 15. DISCONTINUED OPERATIONS**

In September 2008, the assets of Belvedere Trust and the assets of BT Management were assigned for the benefit of their creditors to an independent third party. As control of these operations was turned over to this third party, Belvedere Trust and BT Management were deconsolidated. We recognized a gain on the disposition of discontinued operations of approximately \$7.6 million. As a result, there were no remaining assets or liabilities recorded on our financial statements for these entities at September 30, 2008. At December 31, 2007, there was approximately \$38 thousand in assets of discontinued operations and approximately \$7.8 million in liabilities of discontinued operations.

The net income (loss) from discontinued operations for the three years ended December 31, 2009, 2008 and 2007 was as follows: There was no net income or loss for the year ended December 31, 2009. The net income of \$7.6 million for the year ended December 31, 2008 was from the gain on disposition of the discontinued operations. The net loss of \$(151.3) million for the year ended December 31, 2007 was due primarily to the sales and impairments of assets of discontinued operations.

The major components of income and expense for the discontinued operations for the year ending December 31, 2007 are as follows (in thousands):

	December 31, 2007
Interest income:	
Interest on BT Other MBS	\$ 12,352
Interest on BT Residential Loans	54,360
	66,712
Interest expense:	
Interest expense on repurchase agreements	10,109
Interest expense on whole loan financing facilities	
Interest expense on MBS issued	52,224
	62,333
Net interest income	4,379
Loss on sale and impairment of Belvedere Trust's assets	(151,184)
Expenses	(4,483)
Net loss from discontinued operations	\$ (151,288)

NOTE 16. SUBSEQUENT EVENTS

We have evaluated subsequent events through February 26, 2010, which is the date that our consolidated financial statements are issued. For purposes of these financial statements, we have not evaluated any subsequent events after this date.

On January 27, 2010, we declared a Series A Preferred Stock dividend of \$0.539063 per share and a Series B Preferred Stock dividend of \$0.390625 per share, each of which is payable on April 15, 2010 to our holders of record of Series A Preferred Stock and Series B Preferred Stock, respectively, as of the close of business on March 31, 2010.

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On January 27, 2010, our board of directors authorized the Company to acquire up to 5,850,000 shares of our common stock, or approximately 5% of our total shares of common stock outstanding, through a stock

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repurchase plan. The shares are expected to be acquired at prevailing prices through open market transactions. The manner, price, number and timing of share repurchases will be subject to market conditions and applicable SEC rules. From January 1, 2010 through February 25, 2010, we had repurchased an aggregate of 173 thousand shares of our common stock at an average price of \$6.92 per share under this program.

From January 1, 2010 through February 25, 2010, there were three transactions to convert an aggregate of 6,700 shares of Series B Preferred Stock into an aggregate of 21,105 shares of our common stock (based on the then current conversion rate of 3.1505).

Recently, Freddie Mac and Fannie Mae announced that they would be repurchasing seriously delinquent mortgage loans from the MBS pools which they guarantee. Based on the information provided by Fannie Mae and Freddie Mac, we expect that these buybacks will occur over a period of several months beginning March 2010. We expect that Fannie Mae's and Freddie Mac's buying seriously delinquent mortgages may result in an increase in prepayment rates in general and may impact our MBS portfolio.

As of December 31, 2009, 79% of Anworth's MBS were guaranteed by Fannie Mae and 21% were guaranteed by Freddie Mac. ARM loans are experiencing higher delinquency rates than fixed-rate loans, and loans originated in 2006 and 2007 are experiencing higher delinquency rates than loans originated in other years. The following table provides information about Anworth's MBS portfolio as of December 31, 2009.

Mortgage Type	Year of Origination	Portfolio Percentage (Based on 12/31/09 Principal Balance)
ARM	2009	7%
	2008	11%
	2007	21%
	2006	24%
	2005	12%
	2004 or earlier	11%
Fixed-Rate	All	13%

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EXHIBIT INDEX

Exhibit	
Number	Description
1.1	Controlled Equity Offering Sales Agreement dated May 14, 2008 between Anworth Mortgage Asset Corporation and Cantor Fitzgerald & Co. (incorporated by reference from our Current Report on Form 8-K filed with the SEC on May 15, 2008)
3.1	Amended Articles of Incorporation of Anworth (incorporated by reference from our Registration Statement on Form S-11, Registration No. 333-38641, which became effective under the Securities Act of 1933 on March 12, 1998)
3.2	Amended Bylaws of the Company (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 13, 2009)
3.3	Articles of Amendment to Amended Articles of Incorporation (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the SEC on May 14, 2003)
3.4	Articles Supplementary for Series A Cumulative Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on November 3, 2004)
3.5	Articles Supplementary for Series A Cumulative Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 21, 2005)
3.6	Articles Supplementary for Series B Cumulative Convertible Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 30, 2007)
3.7	Articles Supplementary for Series B Cumulative Convertible Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on May 21, 2007)
3.8	Articles of Amendment to Amended Articles of Incorporation (incorporated by reference from our Current Report on Form 8-K filed with the SEC on May 28, 2008)
4.1	Specimen Common Stock Certificate (incorporated by reference from our Registration Statement on Form S-11, Registration No. 333-38641, which became effective under the Securities Act of 1933 on March 12, 1998)
4.2	Specimen Series A Cumulative Preferred Stock Certificate (incorporated by reference from our Current Report on Form 8-K filed with the SEC on November 3, 2004)
4.3	Specimen Series B Cumulative Convertible Preferred Stock Certificate (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 30, 2007)
4.4	Specimen Anworth Capital Trust I Floating Rate Preferred Stock Certificate (liquidation amount \$1,000 per Preferred Security) (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.5	Specimen Anworth Capital Trust I Floating Rate Common Stock Certificate (liquidation amount \$1,000 per Common Security) (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.6	Specimen Anworth Floating Rate Junior Subordinated Note Due 2035 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.7	Junior Subordinated Indenture dated as of March 15, 2005, between Anworth and JPMorgan Chase Bank (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
10.1	2002 Incentive Compensation Plan (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the SEC on May 17, 2002), as amended by Amendment No. 1 to 2002 Incentive Compensation Plan (incorporated by reference from our Current Report on Form 8-K filed with the SEC on October 15, 2009)

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Exhibit

Number	Description
10.2*	2004 Equity Compensation Plan (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the SEC on April 26, 2004)
10.3	2007 Dividend Equivalent Rights Plan (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the SEC on April 26, 2007)
10.4*	2009 Dividend Reinvestment and Stock Purchase Plan (incorporated by reference from our Registration Statement on Form S-3ASR, Registration No. 333-164047, which became effective under the Act on December 28, 2009)
10.5*	Employment Agreement dated January 1, 2002, between the Manager and Lloyd McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002) as amended by Addenda dated April 18, 2002 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002), May 28, 2004 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004, as filed with the SEC on August 9, 2004), June 27, 2006 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006), February 22, 2008 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on February 27, 2008), December 30, 2008 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 2, 2009) and October 14, 2009 (incorporated by reference from our Current Report on Form 8-K, filed with the SEC on October 15, 2009).
10.6*	Employment Agreement dated January 1, 2002, between the Manager and Heather U. Baines (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002) as amended by Addenda dated April 18, 2002 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002), June 27, 2006 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006) and February 13, 2008 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on February 15, 2008) and October 14, 2009 (incorporated by reference from our Current Report on Form 8-K, filed with the SEC on October 15, 2009).
10.7*	Employment Agreement dated January 1, 2002, between the Manager and Joseph E. McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002) as amended by Addenda dated April 18, 2002 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002), June 13, 2002 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002), May 28, 2004 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004, as filed with the SEC on August 9, 2004), June 27, 2006 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006), February 13, 2008 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on February 15, 2008), February 22, 2008 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on February 27, 2008), December 30, 2008 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 2, 2009) and October 14, 2009 (incorporated by reference from our Current Report on Form 8-K, filed with the SEC on October 15, 2009).
10.8	Sublease dated June 13, 2002, between Anworth and PIA (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002) as amended by Amendment to Sublease dated July 8, 2003 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, as filed with the SEC on August 8, 2003)

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Exhibit	
Number	Description
10.9	Deferred Compensation Plan (incorporated by reference from our Annual Report on Form 10-K for the year ended December 31, 2002, as filed with the SEC on March 26, 2003)
10.10*	Purchase Agreement dated as of March 15, 2005, by and among Anworth, Anworth Capital Trust I, TABERNA Preferred Funding I, Ltd., and Merrill Lynch International (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
10.11	Second Amended and Restated Trust Agreement dated as of September 26, 2005 by and among Anworth, JPMorgan Chase Bank, National Association, Chase Bank USA, National Association, Lloyd McAdams, Joseph McAdams, Thad Brown and the several Holders, as defined therein. (incorporated by reference from our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, as filed with the SEC on March 16, 2006)
10.12*	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Thad M. Brown (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006)
10.13*	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Charles J. Siegel (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006)
10.14	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Evangelos Karagiannis (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006)
10.15*	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Bistra Pashamova (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006)
10.16	Administrative Services Agreement dated December 29, 2008, between Anworth and PIA (incorporated by reference from our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, as filed with the SEC on March 12, 2009)
12.1	Computation of Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends
14.1	Code of Ethics and Business Conduct (incorporated by reference from our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as filed with the SEC on March 16, 2007)
21.1	Subsidiaries of the Registrant
23.1	Consent of McGladrey & Pullen, LLP
23.2	Consent of BDO Seidman, LLP
31.1	Certification of the Principal Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934
31.2	Certification of the Principal Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934
32.1	Certifications of the Principal Executive Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certifications of the Principal Financial Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Represents a management contract or compensatory plan, contract or arrangement in which any director or any of the named executives participates.