

CAPSTEAD MORTGAGE CORP

Form 10-Q

August 01, 2011

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended: **June 30, 2011**

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: 001-08896

**CAPSTEAD MORTGAGE CORPORATION**

(Exact name of Registrant as specified in its Charter)

**Maryland**

(State or other jurisdiction of

incorporation or organization)

**75-2027937**

(I.R.S. Employer

Identification No.)

**8401 North Central Expressway, Suite 800, Dallas, TX**

(Address of principal executive offices)

**75225**

(Zip Code)

**(214) 874-2323**

(Registrant's telephone number, including area code)

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

### APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock (\$0.01 par value)

84,395,970 as of August 1, 2011

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**FORM 10-Q**  
**FOR THE QUARTER ENDED JUNE 30, 2011**  
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**Table of Contents****ITEM 1. FINANCIAL STATEMENTS****PART I. FINANCIAL INFORMATION****CAPSTEAD MORTGAGE CORPORATION****CONSOLIDATED BALANCE SHEETS***(in thousands, except per share amounts)*

|  | <i>June 30, 2011</i> | <i>December 31, 2010</i> |
|--|----------------------|--------------------------|
|  | <i>(unaudited)</i>   |                          |
| <b>Assets:</b>   |                      |                          |
| Mortgage securities and similar investments<br>(\$10.96 and \$8.22 billion pledged under repurchase arrangements at June 30, 2011 and<br>December 31, 2010, respectively)  | \$11,424,161         | \$8,515,691              |
| Cash collateral receivable from interest rate swap counterparties  | 33,327               | 35,289                   |
| Interest rate swap agreements at fair value  | 9,356                | 9,597                    |
| Cash and cash equivalents  | 258,377              | 359,590                  |
| Receivables and other assets   | 91,404               | 76,078                   |
| Investments in unconsolidated affiliates   | 3,117                | 3,117                    |
|  | \$11,819,742         | \$8,999,362              |
| <b>Liabilities:</b>  |                      |                          |
| Repurchase arrangements and similar borrowings   | \$10,437,387         | \$7,792,743              |
| Cash collateral payable to interest rate swap counterparties   | 600                  | 9,024                    |
| Interest rate swap agreements at fair value  | 19,962               | 16,337                   |
| Unsecured borrowings   | 103,095              | 103,095                  |
| Common stock dividend payable  | 39,132               | 27,401                   |
| Accounts payable and accrued expenses  | 22,669               | 23,337                   |
|  | 10,622,845           | 7,971,937                |
| <b>Stockholders equity:</b>  |                      |                          |
| Preferred stock - \$0.10 par value; 100,000 shares authorized:   |                      |                          |
| \$1.60 Cumulative Preferred Stock, Series A, 187 shares issued and outstanding at June 30, 2011<br>and December 31, 2010 (\$3,072 aggregate liquidation preference)  | 2,618                | 2,620                    |
| \$1.26 Cumulative Convertible Preferred Stock, Series B, 15,865 and 15,819 shares issued and<br>outstanding at June 30, 2011 and December 31, 2010, respectively (\$180,543 aggregate<br>liquidation preference) | 177,364              | 176,703                  |
| Common stock - \$0.01 par value; 250,000 shares authorized: 81,311 and 70,259 shares issued<br>and outstanding at June 30, 2011 and December 31, 2010, respectively  | 813                  | 703                      |
| Paid-in capital  | 1,170,620            | 1,028,382                |
| Accumulated deficit  | (354,883)            | (354,883)                |
| Accumulated other comprehensive income   | 200,365              | 173,900                  |
|  | 1,196,897            | 1,027,425                |

\$11,819,742

\$8,999,362

*See accompanying notes to consolidated financial statements.*

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**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**

*(in thousands, except per share amounts)*

*(unaudited)*

|  | <i>Quarter Ended</i> |                | <i>Six Months Ended</i> |                |
|--|----------------------|----------------|-------------------------|----------------|
|  | <i>June 30</i>       | <i>June 30</i> | <i>June 30</i>          | <i>June 30</i> |
|  | <i>2011</i>          | <i>2010</i>    | <i>2011</i>             | <i>2010</i>    |
| <b>Interest income:</b>  |                      |                |                         |                |
| Mortgage securities and similar investments                          | \$ 63,136            | \$ 47,634      | \$ 116,277              | \$ 107,784     |
| Other  | 58                   | 135            | 171                     | 227            |
|  | 63,194               | 47,769         | 116,448                 | 108,011        |
| <b>Interest expense:</b>   |                      |                |                         |                |
| Repurchase arrangements and similar borrowings                       | (13,706)             | (11,146)       | (26,028)                | (24,514)       |
| Unsecured borrowings   | (2,187)              | (2,187)        | (4,374)                 | (4,374)        |
| Other  | (1)                  |                | (5)                     |                |
|  | (15,894)             | (13,333)       | (30,407)                | (28,888)       |
|  | 47,300               | 34,436         | 86,041                  | 79,123         |
| <b>Other revenue (expense):</b>                                      |                      |                |                         |                |
| Miscellaneous other revenue (expense)                                | (599)                | (98)           | (817)                   | (303)          |
| Incentive compensation   | (1,487)              | (1,330)        | (2,720)                 | (2,745)        |
| Salaries and benefits  | (1,672)              | (1,463)        | (3,373)                 | (3,106)        |
| Other general and administrative expense                             | (1,066)              | (1,851)        | (2,028)                 | (2,903)        |
|  | (4,824)              | (4,742)        | (8,938)                 | (9,057)        |
| <b>Income before equity in earnings of unconsolidated affiliates</b> | 42,476               | 29,694         | 77,103                  | 70,066         |
| <b>Equity in earnings of unconsolidated affiliates</b>               | 65                   | 65             | 130                     | 130            |
| <b>Net income</b>  | \$ 42,541            | \$ 29,759      | \$ 77,233               | \$ 70,196      |
| <b>Net income available to common stockholders:</b>                  |                      |                |                         |                |
| Net income   | \$ 42,541            | \$ 29,759      | \$ 77,233               | \$ 70,196      |
| Less cash dividends paid on preferred shares                         | (5,060)              | (5,059)        | (10,118)                | (10,117)       |
|  | \$ 37,481            | \$ 24,700      | \$ 67,115               | \$ 60,079      |
| <b>Net income per common share:</b>                                  |                      |                |                         |                |
| Basic  | \$0.48               | \$0.35         | \$0.90                  | \$0.86         |
| Diluted  | 0.48                 | 0.35           | 0.90                    | 0.86           |

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**Cash dividends declared per share:**

|                    |         |         |         |         |
|--------------------|---------|---------|---------|---------|
| Common             | \$0.480 | \$0.360 | \$0.890 | \$0.860 |
| Series A Preferred | 0.400   | 0.400   | 0.800   | 0.800   |
| Series B Preferred | 0.315   | 0.315   | 0.630   | 0.630   |

*See accompanying notes to consolidated financial statements.*

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**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

*(in thousands, unaudited)*

|   | <i>Six Months Ended June 30</i> |                |
|---|---------------------------------|----------------|
|   | <i>2011</i>                     | <i>2010</i>    |
| <b>Operating activities:</b>  |                                 |                |
| Net income  | \$ 77,233                       | \$ 70,196      |
| Noncash items:  |                                 |                |
| Amortization of investment premiums   | 28,351                          | 28,808         |
| Depreciation and other amortization   | 107                             | 109            |
| Equity-based compensation costs   | 884                             | 762            |
| Amounts related to interest rate swap agreements  | (116)                           | (814)          |
| Impairment charge related to real estate held for sale  | 470                             |                |
| Net change in mortgage securities principal remittance receivable                                 | (6,405)                         | 5,582          |
| Net change in remaining receivables, other assets, accounts payable and accrued expenses          | (439)                           | (9,339)        |
| <br>Net cash provided by operating activities   | <br>100,085                     | <br>95,304     |
| <b>Investing activities:</b>  |                                 |                |
| Purchases of mortgage securities and similar investments  | (3,858,053)                     | (1,240,630)    |
| Purchased interest receivable related to purchases of mortgage securities and similar investments | (8,290)                         | (2,590)        |
| Principal collections on mortgage securities and similar investments                              | 951,679                         | 1,620,792      |
| <br>Net cash (used in) provided by investing activities   | <br>(2,914,664)                 | <br>377,572    |
| <b>Financing activities:</b>  |                                 |                |
| Proceeds from repurchase arrangements and similar borrowings                                      | 37,924,609                      | 35,120,420     |
| Principal payments on repurchase arrangements and similar borrowings                              | (35,279,964)                    | (35,658,310)   |
| Decrease (increase) in cash collateral receivable from interest rate swap counterparties          | 1,962                           | (4,202)        |
| Decrease in cash collateral payable to interest rate swap counterparties                          | (8,424)                         |                |
| Capital stock transactions  | 143,347                         | 10,233         |
| Dividends paid  | (68,164)                        | (82,607)       |
| <br>Net cash provided by (used in) financing activities   | <br>2,713,366                   | <br>(614,466)  |
| <br><b>Net change in cash and cash equivalents</b>  | <br>(101,213)                   | <br>(141,590)  |
| Cash and cash equivalents at beginning of period  | 359,590                         | 409,623        |
| <br><b>Cash and cash equivalents at end of period</b>   | <br>\$ 258,377                  | <br>\$ 268,033 |

*See accompanying notes to consolidated financial statements.*

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**CAPSTEAD MORTGAGE CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2011**

*(unaudited)*

**NOTE 1 BUSINESS**

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a REIT ) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as Capstead or the Company. Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage ( ARM ) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the GSEs ), or by an agency of the federal government, Ginnie Mae. Agency-guaranteed residential mortgage pass-through securities ( Agency Securities ) are considered to have limited, if any, credit risk, particularly in light of the conservatorship of the GSEs by the federal government.

**NOTE 2 BASIS OF PRESENTATION**

***Interim Financial Reporting and Reclassifications***

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2011. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2010. Certain prior year amounts have been reclassified to conform to the current year presentation.

**NOTE 3 EARNINGS PER COMMON SHARE**

Basic earnings per common share is computed by dividing net income, after deducting preferred share dividends and adjusting for the impact of unvested stock awards deemed to be participating securities, by the weighted average number of common shares outstanding, calculated excluding unvested stock awards. Diluted earnings per common share is computed by dividing net income, after deducting dividends on convertible preferred shares when such shares are antidilutive and similar adjustments for participating securities, by the weighted average number of common shares and common share equivalents outstanding calculated excluding unvested stock awards, giving effect to equity awards and convertible preferred shares when such awards and shares are dilutive. For calculation purposes the Series A and B preferred shares are considered dilutive whenever basic earnings per common share exceeds each Series dividend divided by the conversion rate applicable for that period. Unvested stock awards that are deemed participating securities are included in the calculation of diluted earnings per share, if dilutive, under either the two class method or the treasury stock method, depending upon which method produces the more dilutive result.

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Components of the computation of basic and diluted earnings per common share were as follows (dollars in thousands, except per share amounts):

|  | <i>Quarter Ended</i> |             | <i>Six Months Ended</i> |             |
|--|----------------------|-------------|-------------------------|-------------|
|  | <i>June 30</i>       |             | <i>June 30</i>          |             |
|  | <i>2011</i>          | <i>2010</i> | <i>2011</i>             | <i>2010</i> |
| <b>Basic earnings per common share</b>                 |                      |             |                         |             |
| Numerator for basic earnings per common share:         |                      |             |                         |             |
| Net income   | \$ 42,541            | \$ 29,759   | \$ 77,233               | \$ 70,196   |
| Series A and B preferred share dividends               | (5,060)              | (5,059)     | (10,118)                | (10,117)    |
| Unvested stock award participation in earnings         | (145)                | (138)       | (274)                   | (333)       |
|  | \$ 37,336            | \$ 24,562   | \$ 66,841               | \$ 59,746   |
| Denominator for basic earnings per common share:       |                      |             |                         |             |
| Weighted average common shares outstanding             | 77,631               | 70,124      | 74,652                  | 69,752      |
| Average unvested stock awards outstanding              | (460)                | (390)       | (459)                   | (388)       |
|  | 77,171               | 69,734      | 74,193                  | 69,364      |
|  | \$0.48               | \$0.35      | \$0.90                  | \$0.86      |
| <b>Diluted earnings per common share</b>               |                      |             |                         |             |
| Numerator for diluted earnings per common share:       |                      |             |                         |             |
| Net income   | \$ 42,541            | \$ 29,759   | \$ 77,233               | \$ 70,196   |
| Dividends on antidilutive convertible preferred shares | (4,985)              | (4,983)     | (9,968)                 | (9,966)     |
| Unvested stock award participation in earnings         | (145)                | (138)       | (274)                   | (333)       |
|  | \$ 37,411            | \$ 24,638   | \$ 66,991               | \$ 59,897   |
| Denominator for diluted earnings per common share:     |                      |             |                         |             |
| Weighted average common shares outstanding             | 77,631               | 70,124      | 74,652                  | 69,752      |
| Average unvested stock awards outstanding              | (460)                | (390)       | (459)                   | (388)       |
| Net effect of dilutive stock and option awards         | 80                   | 28          | 73                      | 42          |
| Net effect of dilutive convertible preferred shares    | 309                  | 310         | 309                     | 310         |
|  | 77,560               | 70,072      | 74,575                  | 69,716      |
|  | \$0.48               | \$0.35      | \$0.90                  | \$0.86      |

Potentially dilutive securities excluded from the computation of earnings per share because the effect of inclusion was antidilutive during the indicated periods were as follows (in thousands):

|  | <i>Quarter Ended</i> |             | <i>Six Months Ended</i> |             |
|--|----------------------|-------------|-------------------------|-------------|
|  | <i>June 30</i>       |             | <i>June 30</i>          |             |
|  | <i>2011</i>          | <i>2010</i> | <i>2011</i>             | <i>2010</i> |
| Antidilutive convertible preferred shares                              | 15,865               | 15,819      | 15,865                  | 15,819      |
| Antidilutive equity awards excludable under the treasury stock method: |                      |             |                         |             |
| Shares issuable under option awards                                    | 10                   | 70          | 10                      | 40          |

Unvested stock awards

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*Mortgage securities and similar investments* and related weighted average coupon rates ( net WAC ) and average yields classified by collateral type and interest rate characteristics were as follows (dollars in thousands):

|                                      | <i>Principal<br/>Balance</i> | <i>Investment<br/>Premiums</i> | <i>Basis</i>  | <i>Carrying<br/>Amount <sup>(a)</sup></i> | <i>Net<br/>WAC<br/><sup>(b)</sup></i> | <i>Average<br/>Yield <sup>(b)</sup></i> |
|--------------------------------------|------------------------------|--------------------------------|---------------|---|---------------------------------------|---|
| <b>June 30, 2011</b>                 |                              |                                |               |   |                                       |   |
| Agency Securities:                   |                              |                                |               |   |                                       |   |
| Fannie Mae/Freddie Mac:              |                              |                                |               |   |                                       |   |
| Fixed-rate                           | \$ 4,386                     | \$ 13                          | \$ 4,399      | \$ 4,410                                  | 6.77%                                 | 6.49%                                   |
| ARMs                                 | 9,705,239                    | 251,605                        | 9,956,844     | 10,154,164                                | 3.03                                  | 2.36                                    |
| Ginnie Mae ARMs                      | 1,206,258                    | 32,949                         | 1,239,207     | 1,252,697                                 | 3.20                                  | 2.54                                    |
|                                      | 10,915,883                   | 284,567                        | 11,200,450    | 11,411,271                                | 3.05                                  | 2.38                                    |
| Residential mortgage loans:          |                              |                                |               |   |                                       |   |
| Fixed-rate                           | 3,351                        | 6                              | 3,357         | 3,357                                     | 6.97                                  | 6.50                                    |
| ARMs                                 | 6,118                        | 23                             | 6,141         | 6,141                                     | 3.49                                  | 3.98                                    |
|                                      | 9,469                        | 29                             | 9,498         | 9,498                                     | 4.72                                  | 4.84                                    |
| Collateral for structured financings | 3,337                        | 55                             | 3,392         | 3,392                                     | 8.04                                  | 7.88                                    |
|                                      | \$ 10,928,689                | \$ 284,651                     | \$ 11,213,340 | \$ 11,424,161                             | 3.05                                  | 2.38                                    |
| <b>December 31, 2010</b>             |                              |                                |               |   |                                       |   |
| Agency Securities:                   |                              |                                |               |   |                                       |   |
| Fannie Mae/Freddie Mac:              |                              |                                |               |   |                                       |   |
| Fixed-rate                           | \$ 4,927                     | \$ 14                          | \$ 4,941      | \$ 4,955                                  | 6.78%                                 | 6.60%                                   |
| ARMs                                 | 7,660,269                    | 158,260                        | 7,818,529     | 7,991,122                                 | 3.09                                  | 2.49                                    |
| Ginnie Mae ARMs                      | 489,579                      | 8,030                          | 497,609       | 505,376                                   | 3.12                                  | 2.57                                    |
|                                      | 8,154,775                    | 166,304                        | 8,321,079     | 8,501,453                                 | 3.09                                  | 2.50                                    |
| Residential mortgage loans:          |                              |                                |               |   |                                       |   |
| Fixed-rate                           | 3,455                        | 6                              | 3,461         | 3,461                                     | 6.98                                  | 7.03                                    |
| ARMs                                 | 7,235                        | 24                             | 7,259         | 7,259                                     | 3.45                                  | 3.79                                    |
|                                      | 10,690                       | 30                             | 10,720        | 10,720                                    | 4.59                                  | 4.83                                    |
| Collateral for structured financings | 3,461                        | 57                             | 3,518         | 3,518                                     | 7.97                                  | 8.07                                    |
| Senior notes                         |                              |                                |               |   |                                       | 8.75                                    |
|                                      | \$ 8,168,926                 | \$ 166,391                     | \$ 8,335,317  | \$ 8,515,691                              | 3.10                                  | 2.51                                    |

(a) Includes unrealized gains and losses for securities classified as available-for-sale, if applicable, (see NOTE 9).

(b) Net WAC is presented net of servicing and other fees and represents the cash yield inherent in the portfolio as of the indicated balance sheet date, before amortization of investment premiums. Average yield is presented for the quarter then ended, calculated including the amortization of investment premiums

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*and excluding unrealized gains and losses.*

Agency Securities carry an implied AAA rating and therefore limited credit risk, particularly in light of the conservatorship of the GSEs by the federal government in 2008. Residential mortgage loans held by the Company were originated prior to 1995 when Capstead operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities obtained through the above-mentioned mortgage conduit that are pledged to secure repayment of the structured financings. The credit risk for these securities is borne by the related bondholders. The maturity of mortgage securities is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, the actual maturity of the Company's mortgage securities will be significantly shorter than the portfolio's weighted average contractual maturity of 287 months.

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Fixed-rate investments are generally Agency Securities backed by mortgage loans with fixed rates of interest. Adjustable-rate investments generally are ARM Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate ( CMT ) or the one-year London interbank offered rate ( LIBOR ), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

Capstead classifies its ARM securities based on each security's average number of months until coupon reset ( months to roll ). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. Current-reset ARM securities have a months to roll of less than 18 months while longer-to-reset ARM securities have a months to roll of 18 months or greater. As of June 30, 2011, the average months to roll for the Company's \$8.74 billion (basis) in current-reset ARM securities was 5.8 months while the average months-to-roll for the Company's \$2.46 billion (basis) in longer-to-reset ARM securities was 44.1 months.

Under variable interest entity accounting rules, the Company has consolidated two Dallas, Texas townhome developments that are collateral for subordinated loans made by the Company. The underlying collateral consisted of 15 unsold completed units with a basis of \$3.6 million at June 30, 2011 and is included in *Receivables and other assets* on the balance sheet. Included in *Miscellaneous other revenue (expense)* is a \$470,000 impairment charge recorded in June 2011 reflecting slow sales of these units and poor housing market conditions. The Company remains a subordinated participant in the lending group to the Four Seasons resort in Nevis, West Indies which was foreclosed on in May 2010. The resort had been closed since October 2008 after sustaining hurricane damage and reopened in December 2010. The Company wrote off its \$39.2 million investment in December 2009; a recovery on this investment, if any, would come from the eventual disposition of the resort by the lending group which is not expected to occur for several years.

**NOTE 5 INVESTMENTS IN UNCONSOLIDATED AFFILIATES**

To facilitate the issuance of *Unsecured borrowings*, Capstead formed and capitalized three Delaware statutory trusts through the issuance to the Company of the trusts' common securities totaling \$3.1 million (see NOTE 7). The Company's equity in the earnings of the trusts consists solely of the common trust securities' pro rata share in interest accruing on *Unsecured borrowings* issued to the trusts.

**NOTE 6 REPURCHASE ARRANGEMENTS AND SIMILAR****BORROWINGS, INCLUDING RELATED HEDGING ACTIVITY**

Capstead generally pledges its *Mortgage securities and similar investments* as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. Repurchase arrangements involve the sale and a simultaneous agreement to repurchase the transferred assets or similar assets at a future date. The amount borrowed generally is equal to the fair value of the assets pledged less an agreed-upon discount, referred to as a haircut. At June 30, 2011, haircuts for pledged Agency Securities averaged 4.6 percent of the fair value of the pledged assets, exclusive of monthly principal and interest remittance receivables.

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Repurchase arrangements entered into by the Company are accounted for as financings and require the repurchase of the transferred securities at the end of each arrangement's term, typically 30 to 90 days. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. Interest rates on these borrowings are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security paydown factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. The maturity of structured financings is directly affected by prepayments on the related mortgage pass-through securities pledged as collateral and these financings are subject to redemption by the residual bondholders.

Repurchase arrangements and similar borrowings, classified by type of collateral and remaining maturities, and related weighted average interest rates as of the indicated quarter-end were as follows (dollars in thousands):

| <i>Collateral Type</i>   | <i>June 30, 2011</i> |                | <i>December 31, 2010</i> |                |
|--|----------------------|----------------|--------------------------|----------------|
|  | <i>Borrowings</i>    | <i>Average</i> | <i>Borrowings</i>        | <i>Average</i> |
|  | <i>Outstanding</i>   | <i>Rate</i>    | <i>Outstanding</i>       | <i>Rate</i>    |
| Borrowings secured by Agency Securities:   |                      |                |                          |                |
| Remaining maturities of 30 days or less  | \$ 8,817,115         | 0.23%          | \$ 7,554,225             | 0.30%          |
| Remaining maturities of 31 to 90 days  | 1,616,880            | 0.24           | 235,000                  | 0.33           |
| Structured financings secured by private residential mortgage securities               | 3,392                | 8.04           | 3,518                    | 7.97           |
|  | \$10,437,387         | 0.24           | \$ 7,792,743             | 0.31           |
| Quarter-end rates adjusted for effects of related derivatives held as cash flow hedges |                      | 0.56           |                          | 0.63           |

Average borrowings outstanding during the indicated quarters were lower than borrowings outstanding at quarter-end primarily due to portfolio growth and differences in the timing of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

|   | <i>Quarter Ended</i> |                |                          |                |
|---|----------------------|----------------|--------------------------|----------------|
|   | <i>June 30, 2011</i> |                | <i>December 31, 2010</i> |                |
|   | <i>Borrowings</i>    | <i>Average</i> | <i>Borrowings</i>        | <i>Average</i> |
|   | <i>Outstanding</i>   | <i>Rate</i>    | <i>Outstanding</i>       | <i>Rate</i>    |
| Average borrowings and rates for the indicated quarters, adjusted for the effects of related derivatives held as cash flow hedges | \$ 9,801,641         | 0.55%          | \$ 7,468,614             | 0.62%          |

To help mitigate exposure to higher short-term interest rates, Capstead uses currently-paying and forward-starting, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that typically require interest payments for two-year terms. These derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate of current and forecasted 30- to 90-day repurchase arrangements. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements largely offset interest accruing on the related borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company's effective borrowing rate, subject to certain adjustments including the effects of measured



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hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and actual borrowing rates. Capstead's swap agreements hedging short-term interest rates, with an average expiration of 15 months, had the following characteristics at June 30, 2011 (dollars in thousands):

| <i>Quarter of<br/>Contract Expiration</i> | <i>Notional<br/>Amount</i> | <i>Average Fixed Rate<br/>Payment Requirement</i> |
|---|----------------------------|---|
| Currently-paying contracts:               |                            |   |
| Third quarter 2011                        | \$ 400,000                 | 1.33%   |
| Fourth quarter 2011                       | 900,000                    | 1.15  |
| First quarter 2012                        | 800,000                    | 1.10  |
| Third quarter 2012                        | 200,000                    | 0.83  |
| First quarter 2013                        | 1,100,000                  | 0.81  |
| Second quarter 2013                       | 700,000                    | 0.96  |
|   | 4,100,000                  | 1.02  |
| Forward-starting contracts:               |                            |   |
| Third quarter 2013                        | 300,000                    | 0.87  |
| Fourth quarter 2013                       | 500,000                    | 0.78  |
|   | \$ 4,900,000               |   |

Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with Fair Value Measurements and Disclosures (ASC 820). In determining fair value estimates for these derivatives, the Company utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts based on expected future interest rates derived from observable market interest rate curves. The Company also incorporates both its own nonperformance risk and its counterparties' nonperformance risk in determining the fair value of its interest rate swap derivatives. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation of these agreements. The following tables include fair value and other related disclosures regarding all derivatives held as of and for the indicated periods (in thousands):

|   | <i>Location in<br/>Balance Sheet</i> | <i>June 30,<br/>2011</i> | <i>December 31,<br/>2010</i> |
|---|--------------------------------------|--------------------------|------------------------------|
| <b>Balance sheet-related</b>  |                                      |                          |                              |
| Interest rate swap agreements in a gain position (an asset) related to:   |                                      |                          |                              |
| Repurchase arrangements and similar borrowings                            | (a)                                  | \$ 551                   | \$ 734                       |
| Unsecured borrowings (see NOTE 7)   | (a)                                  | 8,805                    | 8,863                        |
|   |                                      | 9,356                    | 9,597                        |
| Interest rate swap agreements in a loss position (a liability) related to |                                      |                          |                              |
| repurchase arrangements and similar borrowings                            | (a)                                  | (19,962)                 | (16,337)                     |
| Related net interest payable  | (b)                                  | (11,589)                 | (9,847)                      |
|   |                                      | \$ (22,195)              | \$(16,587)                   |

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- (a) *The fair value of derivatives with realized and unrealized gains are aggregated and recorded as an asset on the face of the balance sheet separately from the fair value of derivatives with realized and unrealized losses that are recorded as a liability. The amount of unrealized losses that will be recognized in the statement of income over the next twelve months in the form of fixed- and variable-rate swap payments in excess of current market rates totaled \$20.7 million at June 30, 2011.*
- (b) *Included in Accounts payable and accrued expenses on the face of the balance sheet.*

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|   | <i>Location of<br/>Gain or<br/>(Loss)<br/>Recognized<br/>in</i> | <i>Quarter Ended<br/>June 30</i> |             | <i>Six Months Ended<br/>June 30</i> |             |
|---|---|----------------------------------|-------------|-------------------------------------|-------------|
|   |   | <i>2011</i>                      | <i>2010</i> | <i>2011</i>                         | <i>2010</i> |
|   | <i>Net Income</i>   |                                  |             |                                     |             |
| <b><i>Income statement-related</i></b>  |   |                                  |             |                                     |             |
| Components of effect on interest expense:   |   |                                  |             |                                     |             |
| Amount of loss reclassified from AOCI:  |   |                                  |             |                                     |             |
| Effective portion of active positions   |   | \$ (7,467)                       | \$ (6,892)  | \$ (13,579)                         | \$ (15,747) |
| Effective portion of terminated positions <sup>(a)</sup>  |   |                                  |             |                                     | (31)        |
|   |   | (7,467)                          | (6,892)     | (13,579)                            | (15,778)    |
| Amount of gain (loss) recognized<br>(ineffective portion)   |   | 109                              | 383         | (49)                                | 249         |
| Increase in interest expense and decrease in <i>Net income</i> as a<br>result of the use of derivatives | (b)   | \$ (7,358)                       | \$ (6,509)  | \$ (13,628)                         | \$ (15,529) |
| <b><i>Other comprehensive income-related</i></b>  |   |                                  |             |                                     |             |
| Amount of loss recognized in other comprehensive income (loss)<br>(effective portion)                   |   | \$ (16,883)                      | \$ (10,111) | \$ (17,561)                         | \$ (25,223) |

(a) In March 2008 a swap agreement with a \$100 million notional amount was terminated for a realized loss of \$2.3 million which was amortized to earnings over the original two-year term of the derivative (through January 2010).

(b) Included in *Interest expense: Repurchase arrangements and similar borrowings* on the face of the statement of income.

**NOTE 7 UNSECURED BORROWINGS**

*Unsecured borrowings* consist of 30-year junior subordinated notes issued in 2006 and 2005 to three special-purpose statutory trusts. These unconsolidated affiliates were formed to issue \$3.1 million of the trusts' common securities to Capstead and to privately place \$100 million of preferred securities with unrelated third party investors. Included in *Receivables and other assets* are \$2.5 million in remaining issue costs associated with these transactions. Note balances and related weighted average interest rates as of June 30, 2011 and December 31, 2010 (calculated including issue cost amortization) were as follows (dollars in thousands):

|                             | <i>Borrowings</i>  | <i>Average</i> |
|-----------------------------|--------------------|----------------|
|                             | <i>Outstanding</i> | <i>Rate</i>    |
| Junior subordinated notes:  |                    |                |
| Capstead Mortgage Trust I   | \$ 36,083          | 8.31%          |
| Capstead Mortgage Trust II  | 41,238             | 8.46           |
| Capstead Mortgage Trust III | 25,774             | 8.78           |
|                             | \$ 103,095         | 8.49           |

The junior subordinated notes pay interest to the trusts quarterly calculated at fixed rates of 8.19% to 8.685% for ten years from issuance and subsequently at prevailing three-month LIBOR rates plus 3.30% to 3.50% for 20 years, reset quarterly. The trusts remit dividends pro rata to the common and preferred trust securities based on the same terms as the subordinated notes provided that payments on the trusts' common securities

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are subordinate to payments on the related preferred securities. The Capstead Mortgage Trust I notes and trust securities mature in October 2035 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after October 30, 2010. The Capstead Mortgage Trust II notes and trust securities mature in December 2035 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after December 15, 2015. The Capstead Mortgage Trust III notes and trust securities mature in September 2036 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after September 15, 2016.

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During 2010, the Company entered into three forward-starting three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements with notional amounts totaling \$100 million, average fixed rates of 4.09% and 20-year terms coinciding with the floating-rate terms of the Company's *Unsecured borrowings* that begin in 2015 and 2016. These derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate associated with the floating-rate terms of these borrowings. After considering these cash-flow hedges, the effective borrowing rate during the final 20 years of these borrowings will average 7.56%, subject to certain adjustments for the effects of measured hedge ineffectiveness, if any.

**NOTE 8 COMPREHENSIVE INCOME**

Comprehensive income is net income plus other comprehensive income (loss). Other comprehensive income (loss) currently consists of the change in net unrealized gains on available-for-sale mortgage securities and amounts related to derivatives held as cash flow hedges. As of June 30, 2011, the *Accumulated other comprehensive income (loss)* component of *Stockholders' equity* consisted of net unrealized gains on mortgage securities held available-for-sale totaling \$210.8 million and net unrealized losses on derivatives held as cash flow hedges totaling \$10.5 million. The following provides information regarding the components of comprehensive income (in thousands):

|  | <i>Quarter Ended</i><br><i>June 30</i> |             | <i>Six Months Ended</i><br><i>June 30</i> |             |
|--|--|-------------|---|-------------|
|  | <i>2011</i>                            | <i>2010</i> | <i>2011</i>                               | <i>2010</i> |
| Net income   | \$ 42,541                              | \$ 29,759   | \$ 77,233                                 | \$ 70,196   |
| Other comprehensive income (loss):                             |  |             |   |             |
| Amounts related to available-for-sale securities:              |  |             |   |             |
| Change in net unrealized gains                                 | 29,439                                 | 7,048       | 30,447                                    | (3,314)     |
| Amounts related to cash flow hedges:                           |  |             |   |             |
| Change in net unrealized losses                                | (16,883)                               | (10,111)    | (17,561)                                  | (25,223)    |
| Reclassification adjustment for amounts included in net income | 7,467                                  | 6,892       | 13,579                                    | 15,778      |
| Other comprehensive income (loss)                              | 20,023                                 | 3,829       | 26,465                                    | (12,759)    |
| Comprehensive income   | \$ 62,564                              | \$ 33,588   | \$ 103,698                                | \$ 57,437   |

**NOTE 9 DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS**

The following tables and related discussion provide fair value disclosures as of the indicated balance sheet dates for Capstead's financial assets and liabilities, most of which are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management. Excluded from these disclosures are financial instruments for which the Company's cost basis is deemed to approximate fair value due primarily to the short duration of these instruments, including *Cash and cash equivalents*, cash collateral receivable from and payable to interest rate swap counterparties, receivables, payables and borrowings under repurchase arrangements with initial terms of 120 days or less.

The Company's holdings of residential mortgage securities, nearly all of which are classified as available-for-sale, are measured at fair value on a recurring basis using Level Two Inputs in accordance with ASC 820. In determining fair value estimates for mortgage securities the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for repurchase arrangements, provided such pricing levels are considered indicative of actual market clearing transactions. See NOTE 6 for information relative to the valuation of interest rate swap agreements.

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Fair value disclosures for financial instruments other than debt securities were as follows (in thousands):

|   | <i>June 30, 2011</i> |              | <i>December 31, 2010</i> |              |
|---|----------------------|--------------|--------------------------|--------------|
|   | <i>Carrying</i>      | <i>Fair</i>  | <i>Carrying</i>          | <i>Fair</i>  |
|   | <i>Amount</i>        | <i>Value</i> | <i>Amount</i>            | <i>Value</i> |
| Financial assets:   |                      |              |                          |              |
| Residential mortgage loans  | \$ 9,498             | \$ 9,700     | \$ 10,720                | \$ 11,000    |
| Interest rate swap agreements                                       | 9,356                | 9,356        | 9,597                    | 9,597        |
| Financial liabilities:  |                      |              |                          |              |
| Repurchase arrangements with initial terms of greater than 120 days | 316,284              | 316,300      |                          |              |
| Unsecured borrowings  | 103,095              | 105,200      | 103,095                  | 103,800      |
| Interest rate swap agreements                                       | 19,962               | 19,962       | 16,337                   | 16,337       |

Fair value and related disclosures for debt securities were as follows (in thousands):

|  | <i>Basis</i>  | <i>Gross Unrealized</i> |               | <i>Fair Value</i> |
|--|---------------|-------------------------|---------------|-------------------|
|  |               | <i>Gains</i>            | <i>Losses</i> |                   |
| <i>As of June 30, 2011</i>                                     |               |                         |               |                   |
| Agency Securities classified as available-for-sale             | \$ 11,196,191 | \$ 212,005              | \$ 1,184      | \$ 11,407,012     |
| Residential mortgage securities classified as held-to-maturity | 7,651         | 429                     |               | 8,080             |
| <i>As of December 31, 2010</i>                                 |               |                         |               |                   |
| Agency Securities classified as available-for-sale             | 8,316,307     | 181,691                 | 1,317         | 8,496,681         |
| Residential mortgage securities classified as held-to-maturity | 8,290         | 454                     |               | 8,744             |

|  | <i>June 30, 2011</i> |                   | <i>December 31, 2010</i> |                   |
|--|----------------------|-------------------|--------------------------|-------------------|
|  | <i>Fair</i>          | <i>Unrealized</i> | <i>Fair</i>              | <i>Unrealized</i> |
|  | <i>Value</i>         | <i>Loss</i>       | <i>Value</i>             | <i>Loss</i>       |
| Securities in an unrealized loss position: |                      |                   |                          |                   |
| One year or greater                        | \$ 232               | \$ 1              | \$ 1,694                 | \$ 2              |
| Less than one year                         | 568,989              | 1,183             | 334,224                  | 1,315             |
|  | \$ 569,221           | \$ 1,184          | \$ 335,918               | \$ 1,317          |

Managing a leveraged portfolio of primarily ARM Agency Securities is the core focus of Capstead's investment strategy and management expects these securities will be held until payoff absent a major shift in the Company's investment focus. Declines in fair value caused by increases in interest rates are typically modest for investments in relatively short-duration ARM Agency Securities compared to investments in longer-duration, fixed-rate assets. These declines are generally recoverable in a relatively short period of time as the coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment allowing for the potential recovery of financing spreads diminished during periods of rising interest rates.

From a credit risk perspective, the real or implied federal government guarantee associated with Agency Securities, particularly in light of the conservatorship of the GSEs by the federal government, helps ensure that fluctuations in value due to credit risk associated with these securities will be limited. Given that (a) any existing unrealized losses on mortgage securities held by the Company are not attributable to credit risk,

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(b) the Company typically holds its investments to maturity, and (c) it is more likely than not that the Company will not be required to sell any of its investments, none of these investments are considered other-than-temporarily impaired at June 30, 2011.

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**Table of Contents****NOTE 10 COMPENSATION PROGRAMS**

The compensation committee of Capstead's board of directors administers all compensation programs for employees including salaries and related programs, annual incentive compensation and long-term equity-based awards, as well as other benefit programs.

***Performance-based Cash Compensation Program to Augment Base Salaries***

In 2008 the compensation committee implemented a performance-based cash compensation program designed to introduce a variable component to the base compensation for executive officers that provides for payments equal to the per share dividend declared on the Company's common stock multiplied by a notional amount of non-vesting or "phantom" common shares ( "Dividend Equivalent Rights"). Dividend Equivalent Rights are not attached to any stock or option awards and only have the right to receive the same cash distributions that the Company's common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. In July 2010 the committee extended the expiration of previous grants by one year such that at June 30, 2011 all grants expire on July 1, 2013. Dividend Equivalent Rights issued and outstanding and related compensation costs were as follows at June 30, 2011:

| <i>Month of</i> | <i>Total</i> | <i>Quarter Ended</i> | <i>Six Months Ended</i> |
|-----------------|--------------|----------------------|-------------------------|
| <i>Grant</i>    | <i>Grant</i> | <i>June 30, 2011</i> | <i>June 30, 2011</i>    |
| July 2008       | 225,000      | \$108,000            | \$200,000               |
| July 2009       | 225,000      | 108,000              | 200,000                 |
| July 2010       | 60,000       | 29,000               | 54,000                  |
|                 |              | \$245,000            | \$454,000               |

***Annual Incentive Compensation***

To provide employees with an appropriate performance-based annual incentive compensation opportunity, each year the committee approves an incentive formula to create an incentive pool equal to a percentage participation in the Company's earnings in excess of a pre-established performance threshold. This formula is intended to serve as a guideline for the creation of an annual incentive pool. The committee has complete discretion with respect to the amount to be distributed from the pool, including its allocation between executive officers and other employees and the form of payment (e.g., cash or equity awards). Distributions are typically made subsequent to year-end.

The formula approved for 2011 and 2010 includes a minimum performance threshold based on return on average long-term investment capital and a maximum amount, or cap, available to be paid in any one year of 50 basis points multiplied by average long-term investment capital, as defined below. The incentive pool equals a 10% participation in annual earnings, as defined below, in excess of a benchmark amount based on average long-term investment capital, as defined below, multiplied by the greater of 10.00% and 8.00% for 2011 and 2010, respectively, or the average 10-year U.S. Treasury rate plus 200 basis points. Annual earnings for formula purposes equates to *Net income* excluding (i) *Incentive compensation expense*, (ii) any gain or loss from asset sales or writedowns, including impairment charges, and (iii) interest on *Unsecured borrowings*, net of equity in the earnings of related statutory trusts reflected in the balance sheet as *Investments in unconsolidated affiliates*. Average long-term investment capital for formula purposes equates to average *Unsecured borrowings*, net of related investments in statutory trusts, and average *Stockholders' equity*, excluding (i) *Accumulated other comprehensive income*, (ii) incentive compensation accruals, (iii) any gain or loss from asset sales or writedowns, including impairment charges, and (iv) interest accruals on *Unsecured borrowings*.

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During the quarter and six months ended June 30, 2011 the Company recognized *Incentive compensation expense* totaling \$1.5 million and \$2.7 million, respectively, the accruals for which are included in *Accounts payable and accrued expenses*.

**Long-term Equity-based Awards**

The Company sponsors equity-based award plans to provide for the issuance of stock awards, option awards and other long-term equity-based awards to directors and employees (collectively, the Plans). At June 30, 2011, the Plans had 1,180,441 common shares remaining available for future issuance.

The following table includes service-based stock awards issued to directors and employees with related vesting information (subject to certain restrictions, principally continuous service), at June 30, 2011:

| <i>Year of Grant</i> | <i>Grant Date</i> | <i>Total</i>    | <i>Shares Vesting In:</i> |             |             |             |
|----------------------|-------------------|-----------------|---------------------------|-------------|-------------|-------------|
|                      | <i>Fair Value</i> | <i>Original</i> | <i>2011</i>               | <i>2012</i> | <i>2013</i> | <i>2014</i> |
| <i>Grant</i>         | <i>Per Share</i>  | <i>Grants</i>   |                           |             |             |             |
| 2006                 | \$ 8.06           | 218,957         | 42,499                    |             |             |             |
| 2007                 | 12.93             | 156,000         | 22,665                    | 22,498      | 22,497      | 22,497      |
| 2008                 | 12.87             | 6,000           |                           |             |             |             |
| 2009                 | 11.39             | 6,000           |                           |             |             |             |
| 2010                 | 11.64             | 12,000          | 12,000                    |             |             |             |
| 2011                 | 13.23             | 24,000          |                           | 24,000      |             |             |

In 2008 the Company implemented a performance-based stock award program in lieu of its previous practice of issuing service-based awards to employees. As this program is currently configured, the first 50% of awards granted each year vest provided certain performance criteria pertaining to a three-year measurement period that starts at the beginning of the following calendar year are met. The remaining 50% vests provided performance criteria pertaining to a three-year measurement period beginning one year later are met. If the performance criteria are not met at the end of a three-year measurement period, vesting will be deferred and a new three-year measurement period will be established to include the subsequent year, up to and including the seventh calendar year after the year of grant. Any remaining unvested awards will expire if the performance criteria for the final three-year measurement period are not met. The performance criteria establishes an annualized threshold return that must be exceeded for the awards to vest based on the Company's long-term investment capital, subject to certain adjustments, of the greater of 8.0% or the average 10-year U.S. Treasury rate plus 200 basis points.

The following table includes performance-based stock awards issued to employees with related measurement period information at June 30, 2011:

| <i>Year of Grant</i> | <i>Grant Date</i> | <i>Total</i>    | <i>Final</i>       | <i>Remaining Shares with</i>       |             |             |             |
|----------------------|-------------------|-----------------|--------------------|------------------------------------|-------------|-------------|-------------|
|                      | <i>Fair Value</i> | <i>Original</i> | <i>Measurement</i> | <i>Initial Measurement Periods</i> |             |             |             |
| <i>Grant</i>         | <i>Per Share</i>  | <i>Grants</i>   | <i>Period Ends</i> | <i>2011</i>                        | <i>2012</i> | <i>2013</i> | <i>2014</i> |
|                      |                   |                 | <i>December 31</i> |                                    |             |             |             |
| 2008                 | \$10.18           | 140,658         | 2015               | 67,597                             | 67,597      |             |             |
| 2009                 | 14.33             | 110,917         | 2016               |                                    | 55,043      | 55,035      |             |
| 2010                 | 12.44             | 128,766         | 2017               |                                    |             | 64,087      | 64,077      |

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Total stock award activity for the six months ended June 30, 2011 is summarized below:

|   | <i>Number of<br/>Shares</i> | <i>Weighted Average<br/>Grant Date<br/>Fair Value</i> |
|---|-----------------------------|---|
| Stock awards outstanding at December 31, 2010 | 521,100                     | \$11.96   |
| Grants  | 24,000                      | 13.23   |
| Vestings                                      | (77,164)                    | 10.15   |
| Forfeitures                                   | (3,008)                     | 12.27   |
| Stock awards outstanding at June 30, 2011     | 464,928                     | 12.33   |

During the quarter and six months ended June 30, 2011, the Company recognized in *General and administrative expense* \$453,000 and \$880,000, respectively, related to amortization of the grant date fair value of stock awards assuming performance criteria, if applicable, continue to be met for related initial measurement periods. All service-based stock awards and performance-based stock awards granted prior to 2010 are entitled to receive dividends on a current basis without risk of forfeiture if the related awards do not vest. The 2010 performance-based awards defer the payment of dividends accruing during the vesting period until vesting and if the related awards do not vest these accrued dividends will be forfeited. At June 30, 2011 dividends accrued pertaining to these awards totaled \$164,000 and are included in *Common stock dividend payable*. Unrecognized compensation expense for unvested stock awards totaled \$4.0 million as of June 30, 2011, to be expensed over a weighted average period of 1.7 years, assuming related performance criteria are met for the initial measurement periods for performance-based stock awards.

Option awards currently outstanding have contractual terms and vesting requirements at the grant date of ten years and were issued with strike prices equal to the quoted market prices of the Company's common shares on the date of grant. The fair value of each option award was estimated on the date of grant using a Black-Scholes option pricing model. The Company estimated option exercises, expected holding periods and forfeitures based on past experience and expectations for option performance and employee or director attrition. Risk-free rates were based on market rates for the expected life of the options. Expected dividends were based on historical experience and expectations for future performance. Expected volatility factors were based on historical experience. No option awards were granted in 2011 or 2010. In 2009 option awards granted to directors totaled 30,000 common shares with strike prices and grant date fair values of \$11.69 and \$1.52 per share, respectively. Fair values were determined using average expected terms of four years, and volatility factors, dividend yields and risk-free rates of 51%, 14% and 1.70%, respectively.

Option award activity for the six months ended June 30, 2011 is summarized below:

|  | <i>Number of<br/>Shares</i> | <i>Weighted Average<br/>Exercise Price</i> |
|--|-----------------------------|--|
| Option awards outstanding at December 31, 2010 | 288,125                     | \$10.48                                    |
| Exercises                                      | (6,875)                     | 9.61                                       |
| Option awards outstanding at June 30, 2011     | 281,250                     | 10.51                                      |

Exercisable option awards outstanding as of June 30, 2011 totaled 281,250 shares with a weighted average remaining contractual term of 5.82 years, an average exercise price of \$10.51 and an aggregate intrinsic value of \$824,000. The total intrinsic value of option awards exercised during the quarter and six months ended June 30, 2011 was \$9,000 and \$25,000, respectively. During the quarter and six months ended June 30, 2011, the Company recognized in *General and administrative expense* \$1,000 and \$3,000, related to option awards, respectively.

**Table of Contents****Other Benefit Programs**

Capstead sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its officers. In general the Company matches up to 50% of a participant's voluntary contribution up to a maximum of 6% of a participant's compensation and makes discretionary contributions of up to another 3% of compensation regardless of participation in the plans. Company contributions are subject to certain vesting requirements. During the quarter and six months ended June 30, 2011, the Company recognized in *General and administrative expense* \$131,000 and \$243,000 related to contributions to these plans, respectively.

**NOTE 11 NET INTEREST INCOME ANALYSIS**

The following table summarizes interest income, interest expense and weighted average interest rates as well as related changes due to changes in interest rates versus changes in volume (dollars in thousands):

|  | <i>Quarter Ended June 30</i> |                     | <i>2010</i>   |                     | <i>Related Changes in</i> |                |               |
|--|------------------------------|---------------------|---------------|---------------------|---------------------------|----------------|---------------|
|  | <i>2011</i>                  |                     | <i>2010</i>   |                     | <i>Rate*</i>              | <i>Volume*</i> | <i>Total*</i> |
|  | <i>Amount</i>                | <i>Average Rate</i> | <i>Amount</i> | <i>Average Rate</i> |                           |                |               |
| <b>Interest income:</b>                        |                              |                     |               |                     |                           |                |               |
| Mortgage securities and similar investments    | \$63,136                     | 2.38%               | \$47,634      | 2.55%               | \$(3,353)                 | \$18,855       | \$15,502      |
| Other  | 58                           | 0.12                | 135           | 0.19                | (41)                      | (36)           | (77)          |
|  | 63,194                       | 2.34                | 47,769        | 2.47                | (3,394)                   | 18,819         | 15,425        |
| <b>Interest expense:</b>                       |                              |                     |               |                     |                           |                |               |
| Repurchase arrangements and similar borrowings | (13,706)                     | 0.55                | (11,146)      | 0.64                | (1,715)                   | 4,275          | 2,560         |
| Unsecured borrowings                           | (2,187)                      | 8.49                | (2,187)       | 8.49                |                           |                |               |
| Other  | (1)                          | 0.10                |               |                     |                           | 1              | 1             |
|  | (15,894)                     | 0.64                | (13,333)      | 0.76                | (1,715)                   | 4,276          | 2,561         |
|  | \$47,300                     | 1.70                | \$34,436      | 1.71                | \$(1,679)                 | \$14,543       | \$12,864      |

|  | <i>Six Months Ended June 30</i> |                     | <i>2010</i>   |                     | <i>Related Changes in</i> |                |               |
|--|---------------------------------|---------------------|---------------|---------------------|---------------------------|----------------|---------------|
|  | <i>2011</i>                     |                     | <i>2010</i>   |                     | <i>Rate*</i>              | <i>Volume*</i> | <i>Total*</i> |
|  | <i>Amount</i>                   | <i>Average Rate</i> | <i>Amount</i> | <i>Average Rate</i> |                           |                |               |
| <b>Interest income:</b>                        |                                 |                     |               |                     |                           |                |               |
| Mortgage securities and similar investments    | \$116,277                       | 2.37%               | \$107,784     | 2.83%               | \$(19,341)                | \$27,834       | \$8,493       |
| Other  | 171                             | 0.16                | 227           | 0.16                |                           | (56)           | (56)          |
|  | 116,448                         | 2.32                | 108,011       | 2.73                | (19,341)                  | 27,778         | 8,437         |
| <b>Interest expense:</b>                       |                                 |                     |               |                     |                           |                |               |
| Repurchase arrangements and similar borrowings | (26,028)                        | 0.57                | (24,514)      | 0.69                | (4,694)                   | 6,208          | 1,514         |
| Unsecured borrowings                           | (4,374)                         | 8.49                | (4,374)       | 8.49                |                           |                |               |
| Other  | (5)                             | 0.14                |               |                     |                           | 5              | 5             |
|  | (30,407)                        | 0.66                | (28,888)      | 0.80                | (4,694)                   | 6,213          | 1,519         |
|  | \$86,041                        | 1.66                | \$79,123      | 1.93                | \$(14,647)                | \$21,565       | \$6,918       |

\* *The change in interest income and interest expense due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.*

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

**FINANCIAL CONDITION**

***Overview***

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a REIT) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as Capstead or the Company. Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the GSEs), or by an agency of the federal government, Ginnie Mae. Agency-guaranteed residential mortgage pass-through securities (Agency Securities) are considered to have limited, if any, credit risk, particularly in light of the conservatorship of the GSEs by the federal government.

Capstead's investment strategy is to manage a conservatively leveraged portfolio of ARM Agency Securities that can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. This strategy differentiates the Company from its peers because ARM Agency Securities reset to more current interest rates within a relatively short period of time allowing for (a) the recovery of financing spreads diminished during periods of rising interest rates and (b) smaller fluctuations in portfolio values from changes in interest rates compared to portfolios that contain a significant amount of fixed-rate Agency Securities. From a credit-risk perspective, the credit quality of Agency Securities helps ensure that fluctuations in value due to credit risk should be limited and financing at reasonable rates and terms should remain available under stressed market conditions.

Capstead finances its investments with borrowings under repurchase arrangements with commercial banks and other financial institutions supported by its long-term investment capital, which as of June 30, 2011, totaled \$1.30 billion consisting of \$1.02 billion of common and \$180 million of perpetual preferred stockholders' equity (recorded amounts) and \$100 million of long-term unsecured borrowings (net of related investments in statutory trusts). The combination of these borrowings and long-term investment capital is referred to as portfolio leverage and is typically expressed as a ratio. Long-term investment capital increased \$169 million during the six months ended June 30, 2011 reflecting \$143 million in new common and preferred equity capital raised year-to-date under the Company's at-the-market, continuous offering program, together with a net increase in portfolio and swap position valuations. During 2011 the Company increased its holdings of ARM Agency Securities by \$2.91 billion or 34% to \$11.42 billion at June 30, 2011, while repurchase arrangements and similar borrowings increased \$2.64 billion to \$10.44 billion. With this portfolio growth, portfolio leverage increased over one full turn to 8.05 to one by June 30, 2011 from 6.91 to one at December 31, 2010. Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio of Agency Securities in today's market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities (duration is a common measure of market price sensitivity to interest rate movements). Provided capital can continue to be deployed at attractive levels and financing conditions remain favorable, management anticipates maintaining portfolio leverage near current levels in future quarters.

Capstead reported net income of \$43 million and \$77 million or \$0.48 and \$0.90 per diluted common share for the quarter and six months ended June 30, 2011, respectively, compared to \$30 million and \$70 million or \$0.35 and \$0.86 per diluted common share for the same periods in 2010. The increase in earnings can largely be attributed to increases in average outstanding portfolio, newly raised investment capital and higher leverage levels during 2011. Total financing spreads (the difference between yields on

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interest-earning assets and rates on interest-bearing liabilities), averaged 170 and 166 basis points for the quarter and six months ended June 30, 2011, respectively, compared to 171 and 193 basis points during the same periods in 2010. Lower financing spreads in 2011 reflect the effects on portfolio yields of ARM loan coupon interest rates underlying the existing portfolio continuing to reset to more current rates. This reflects the relatively low interest rate environment experienced over the last several years. Additionally, portfolio yields have been affected by higher pricing for portfolio acquisitions than prevalent in past years, which has increased the ratio of the Company's portfolio basis to related unpaid principal balances to 102.60 at June 30, 2011 from 102.04 at December 31, 2010 and 101.40 at December 31, 2009. Investment premiums are amortized to earnings as yield adjustments as the portfolio prepays. These factors more than offset the benefits to financing spreads of lower borrowing costs and lower mortgage prepayment rates experienced during 2011.

The size and composition of Capstead's investment portfolio depends on investment strategies being implemented by management, the availability of investment capital as well as overall market conditions, including the availability of attractively priced investments and suitable financing to appropriately leverage the Company's investment capital. Market conditions are influenced by, among other things, current levels of, and expectations for future levels of, short-term interest rates, mortgage prepayments and market liquidity.

### ***Risk Factors and Critical Accounting Policies***

Under the captions "Risk Factors" and "Critical Accounting Policies" are discussions of risk factors and critical accounting policies affecting Capstead's financial condition and earnings that are an integral part of this discussion and analysis. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company and its financial results.

### ***Common and Preferred Equity Issuances***

During the second quarter of 2011 Capstead raised \$83 million in new common equity capital, after underwriting discounts and offering expenses, by issuing 6.3 million common shares at an average price of \$13.16 per share, after expenses, through the Company's at-the-market, continuous offering program. Year-to-date the Company has raised \$143 million by issuing 10.9 million common shares at an average net price of \$13.07 per share under this program. Additionally, in June 2011 the Company began issuing new Series B perpetual preferred shares under this program, raising \$661,000 in new preferred equity capital through the issuance of 45,700 Series B preferred shares at an average price of \$14.47 per share, after expenses. Subsequent to quarter-end and through the date of this filing, the Company used this program to issue an additional \$42 million in common and perpetual preferred equity capital through the issuance of 3.1 million common shares at an average issue price of \$13.27, after expenses, and 83,000 Series B preferred shares at an average issue price of \$14.55, after expenses. The Company may raise additional capital in future periods using this program or by other means, subject to market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important company-specific news.

### ***Book Value per Common Share***

Nearly all of Capstead's mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company's balance sheet and are therefore included in the calculation of book value per common share (total stockholders' equity, less perpetual preferred share liquidation preferences, divided by common shares outstanding). The fair value of these positions is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels. The Company's investment strategy attempts to mitigate these risks by focusing on investments in Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans with interest rates that reset periodically to more current levels. Because of these characteristics, the

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fair value of Capstead's portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to portfolios that contain a significant amount of non-agency and/or fixed-rate mortgage securities. The following table illustrates the progression of book value per common share for the quarter and six months ended June 30, 2011:

|   | <i>Quarter Ended</i> |                 | <i>Six Months Ended</i> |
|---|----------------------|-----------------|-------------------------|
|   | <i>June 30</i>       | <i>March 31</i> | <i>June 30</i>          |
| Book value per common share, beginning of period  | \$ 12.15             | \$ 12.02        | \$ 12.02                |
| Accretion from capital transactions   | 0.08                 | 0.06            | 0.15                    |
| Dividend distributions in excess of earnings  | (0.02)               | (0.01)          | (0.03)                  |
| Increase in fair value of mortgage securities classified as available-for-sale                        | 0.36                 | 0.01            | 0.37                    |
| Increase (decrease) in fair value of interest rate swap agreements designated as cash flow hedges of: |                      |                 |                         |
| Repurchase arrangements and similar borrowings  | (0.09)               | 0.05            | (0.05)                  |
| Unsecured borrowings  | (0.02)               | 0.02            |                         |
| Book value per common share, end of period  | \$ 12.46             | \$ 12.15        | \$ 12.46                |
| Increase in book value per common share during the indicated periods                                  | \$ 0.31              | \$ 0.13         | \$ 0.44                 |

**Residential Mortgage Investments**

Capstead's investment strategy focuses on managing a large portfolio of residential mortgage investments consisting almost exclusively of ARM Agency Securities. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by the GSEs, which are federally chartered corporations, or an agency of the federal government, Ginnie Mae. The 2008 conservatorship of the GSEs by their federal regulator, and related capital commitments to the GSEs made by the U.S. Treasury, have largely alleviated market concerns regarding the ability of the GSEs to fulfill their guarantee obligations. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration, fixed-rate assets. These declines can be recovered in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment allowing for the potential recovery of financing spreads diminished during periods of rising interest rates. The following table illustrates the progression of Capstead's portfolio of residential mortgage investments for the quarter and six months ended June 30, 2011 (in thousands):

|  | <i>Quarter Ended</i> | <i>Six Months Ended</i> |
|--|----------------------|-------------------------|
|  | <i>June 30, 2011</i> | <i>June 30, 2011</i>    |
| Residential mortgage investments, beginning of period                                    | \$ 10,428,003        | \$ 8,515,691            |
| Increase in unrealized gains on securities classified as available-for-sale              | 29,439               | 30,447                  |
| Portfolio acquisitions (principal amount) at average purchased yields of 2.72% and 2.80% | 1,402,582            | 3,711,443               |
| Investment premiums on acquisitions  | 56,296               | 146,610                 |
| Portfolio runoff (principal amount)  | (476,640)            | (951,679)               |
| Investment premium amortization  | (15,519)             | (28,351)                |
| Residential mortgage investments, end of period  | \$ 11,424,161        | \$ 11,424,161           |
| Average residential mortgage investments outstanding during the indicated periods        | \$ 10,601,719        | \$ 9,802,264            |



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Acquisitions of ARM agency securities totaled \$1.40 billion and \$3.71 billion (principal amount) during the quarter and six months ended June 30, 2011, far outpacing portfolio runoff and contributing to a \$2.91 billion or 34% increase in the portfolio year-to-date. With this portfolio growth, the Company has succeeded in completing the re-leveraging of its existing capital and deploying new common and preferred equity capital raised thus far in 2011. As a result, portfolio leverage increased over one full turn to 8.05 to one by June 30, 2011 from 6.91 to one at December 31, 2010. Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio of Agency Securities in today's market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities. Provided capital can continue to be deployed at attractive levels and financing conditions remain favorable, management anticipates maintaining portfolio leverage near current levels in future quarters.

ARM securities are backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate ( CMT ) or the one-year London interbank offered rate ( LIBOR ), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. As of June 30, 2011, the Company's ARM securities featured the following characteristics (dollars in thousands):

| ARM Type                      | Basis <sup>(a)</sup> | Fully Indexed          |                    | Average                    | Average                      | Average                      | Months  |
|-------------------------------|----------------------|------------------------|--------------------|----------------------------|------------------------------|------------------------------|---------|
|                               |                      | Net WAC <sup>(b)</sup> | WAC <sup>(b)</sup> | Net Margins <sup>(b)</sup> | Periodic Caps <sup>(b)</sup> | Lifetime Caps <sup>(b)</sup> | To Roll |
| <b>Current-reset ARMs:</b>    |                      |                        |                    |                            |                              |                              |         |
| Fannie Mae Agency Securities  | \$ 5,977,489         | 2.66%                  | 2.22%              | 1.70%                      | 3.35%                        | 10.17%                       | 5.1     |
| Freddie Mac Agency Securities | 2,236,564            | 3.61                   | 2.36               | 1.84                       | 2.90                         | 10.69                        | 7.9     |
| Ginnie Mae Agency Securities  | 518,806              | 2.69                   | 1.71               | 1.52                       | 1.00                         | 9.79                         | 5.3     |
| Residential mortgage loans    | 6,141                | 3.49                   | 2.34               | 2.05                       | 1.53                         | 10.99                        | 5.5     |
|                               | 8,739,000            | 2.90                   | 2.23               | 1.73                       | 3.10                         | 10.27                        | 5.8     |
| <b>Longer-to-reset ARMs:</b>  |                      |                        |                    |                            |                              |                              |         |
| Fannie Mae Agency Securities  | 1,214,919            | 3.49                   | 2.49               | 1.76                       | 4.50                         | 8.65                         | 45.2    |
| Freddie Mac Agency Securities | 527,872              | 3.74                   | 2.58               | 1.87                       | 4.61                         | 8.87                         | 46.4    |
| Ginnie Mae Agency Securities  | 720,401              | 3.58                   | 1.72               | 1.51                       | 1.04                         | 8.62                         | 40.5    |
|                               | 2,463,192            | 3.57                   | 2.29               | 1.71                       | 3.51                         | 8.69                         | 44.1    |
|                               | \$ 11,202,192        | 3.05                   | 2.24               | 1.72                       | 3.19                         | 9.92                         | 14.2    |

(a) Basis represents the Company's investment (unpaid principal balance plus unamortized investment premium) before unrealized gains and losses. As of June 30, 2011, the ratio of basis to related unpaid principal balance for the Company's ARM securities was 102.61. This table excludes \$4 million in fixed-rate Agency Securities, \$3 million in fixed-rate residential mortgage loans and \$3 million in private residential mortgage pass-through securities held as collateral for structured financings.

(b) Net WAC, or weighted average coupon, is presented net of servicing and other fees and represents the cash yield inherent in the portfolio as of the indicated date before amortization of investment premiums. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average Net Margins represents the weighted average level over the underlying indexes that the portfolio can adjust to upon reset, usually subject to initial, periodic and/or lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. ARM securities issued by the GSEs with initial fixed-rate periods of five years or longer typically have 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities held by the Company are subject only to lifetime caps. For presentation purposes, Average Periodic Caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime caps. At quarter-end, 72% of current-reset ARMs were subject to periodic caps averaging 1.86%; 11% were subject to initial caps averaging 4.82%; and 17% were subject to lifetime caps, less the current net

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*WAC, averaging 7.30%. All longer-to-reset ARM securities at June 30, 2011 were subject to initial caps.*

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Capstead classifies its ARM securities based on each security's average number of months until coupon reset (months to roll). Months to roll is an indicator of asset duration. Current-reset ARM securities have a months to roll of less than 18 months while longer-to-reset ARM securities have a months to roll of 18 months or greater. After consideration of any applicable initial fixed-rate periods, at June 30, 2011 approximately 72%, 16% and 12% of the Company's ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly, respectively. Additionally, at June 30, 2011 approximately 89% of the Company's current-reset ARM securities have reached an initial coupon reset, while none of its longer-to-reset ARM securities have reached an initial coupon reset. All percentages are approximate and based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances.

Capstead generally pledges its residential mortgage investments as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. Repurchase arrangements involve the sale and a simultaneous agreement to repurchase the transferred assets or similar assets at a future date. The amount borrowed is generally equal to the fair value of the assets pledged less an agreed-upon discount, referred to as a haircut. At June 30, 2011 haircuts for pledged Agency Securities averaged 4.6 percent of the fair value of the pledged assets, exclusive of monthly principal and interest remittance receivables.

Repurchase arrangements entered into by the Company are accounted for as financings and require the repurchase of the transferred securities at the end of each arrangement's term, typically 30 to 90 days. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. Interest rates on these borrowings are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security paydown factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. Conversely, if fair values increase, lenders are required to release collateral back to the Company pursuant to a Company-issued margin call. The Company's borrowings under repurchase arrangements at June 30, 2011 consisted of \$10.44 billion of primarily 30-day borrowings with 24 counterparties at average rates of 0.24%, before the effects of interest rate swap agreements held as cash flow hedges on a designated portion of 30- to 90-day borrowings (see below) and 0.56% including the effects of these derivatives.

To help mitigate exposure to higher short-term interest rates, Capstead uses currently-paying and forward-starting, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that typically require interest payments for two-year terms. Variable payments received by the Company under its swap agreements largely offset interest accruing on a like amount of the Company's 30- to 90-day borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company's effective borrowing rate, subject to certain adjustments including the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and related actual borrowing rates. Under the terms of currently-paying interest rate swap agreements held at June 30, 2011, the Company is required to pay fixed rates of interest averaging 1.02% on notional amounts totaling \$4.10 billion with average remaining interest payment terms of 12 months. Additionally, the Company entered into forward-starting swap agreements with notional amounts totaling \$800 million that will begin requiring interest payments at fixed rates averaging 0.82% in August through November 2011 and will expire in August through November 2013. After consideration of all swap positions entered into as of quarter-end to hedge short-term borrowing rates, the Company's residential mortgage investments

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and related borrowings under repurchase arrangements had durations of approximately 10 1/4 months and 7 months, respectively, for a net duration gap of approximately 3 1/4 months at June 30, 2011. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated committed borrowings if available at attractive terms.

Since ARM Agency Securities typically trade at a premium to the securities' unpaid principal balance, high levels of mortgage prepayments can put downward pressure on yields and financing spreads because the level of mortgage prepayments impacts how quickly investment premiums are written off against earnings as portfolio yields adjustments. Because pricing for ARM Agency Securities has increased over the last several years, investment premium amortization and the level of mortgage prepayments being experienced by the Company has become increasingly important. Total portfolio runoff averaged 17.1% on an annualized basis during the second quarter of 2011 (a constant prepayment rate, or CPR of 14.6%) compared to 19.9% (a 17.4% CPR) during the first quarter of 2011. Management anticipates that mortgage prepayments on newer origination securities, of which the Company owns a limited amount, may trend higher in the third quarter as a result of the recent decline in mortgage interest rates, while prepayments on more seasoned portfolio should continue to be suppressed by low housing prices and credit problems being experienced by many of these borrowers.

***Commercial Investments***

In 2007 and prior years, Capstead periodically augmented its core investment strategy with investments in credit-sensitive commercial real estate-related assets that could earn attractive risk-adjusted returns. In 2008 management concluded that it would not pursue additional investments in commercial real estate loans. Remaining exposure to these non-core investments at June 30, 2011 consisted of less than \$4 million of collateral associated with two townhome development loans. An impairment charge of \$470,000 was included in earnings in June 2011 reflecting slow sales of these townhome units and poor housing market conditions. The Company remains a subordinated participant in the lending group for the Four Seasons resort in Nevis, West Indies which was foreclosed on in May 2010. The resort re-opened in December 2010 after having been closed since October 2008 as a result of sustaining significant hurricane damage. The Company wrote off its \$39 million investment in December 2009; a recovery on this investment, if any, would come from the eventual disposition of the resort by the lending group which is not expected to occur for several years.

***Utilization of Long-term Investment Capital and Potential Liquidity***

Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio of Agency Securities in today's market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities. Borrowings under repurchase arrangements generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Consequently, potential liquidity inherent in the Company's investment portfolio is as important as the actual level of cash and cash equivalents carried on the balance sheet. Potential liquidity is affected by, among other things, current portfolio leverage levels, changes in market value of assets pledged and interest rate swap agreements held as determined by lending and swap counterparties; principal prepayments; collateral requirements of lenders and swap counterparties; and general conditions in the commercial banking and mortgage finance industries. Future levels of portfolio leverage will be dependent upon many factors, including the size and composition of the Company's investment portfolio (see "Liquidity and Capital Resources").

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Capstead's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of June 30, 2011 in comparison with December 31, 2010 (in thousands):

|   | <i>Investments</i> <sup>(a)</sup> | <i>Related Borrowings</i> | <i>Capital Employed</i> <sup>(a)</sup> | <i>Potential Liquidity</i> <sup>(b)</sup> |
|---|-----------------------------------|---------------------------|--|---|
| <b>Balances as of June 30, 2011:</b>                                    |                                   |                           |  |   |
| Mortgage securities and similar investments                             | \$ 11,424,161                     | \$ 10,437,387             | \$ 986,774                             | \$ 447,548                                |
| Cash collateral receivable from swap counterparties, net <sup>(c)</sup> |                                   |                           | 22,121                                 |   |
| Other assets, net of other liabilities                                  |                                   |                           | 287,980                                | 258,377                                   |
|   |                                   |                           | <b>\$ 1,296,875</b>                    | <b>\$ 705,925</b>                         |
| <b>Balances as of December 31, 2010</b>                                 |                                   |                           |  |   |
|   | \$ 8,515,691                      | \$ 7,792,743              | \$ 1,127,403                           | \$ 653,226                                |

(a) Investments are stated at carrying amounts on the Company's balance sheets, which generally reflects management's estimate of fair value as of the indicated date.

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

(c) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties and the fair value of the Company's swap positions as of the indicated date.

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and swap program-related margin calls (requirements to pledge additional collateral or pay down borrowings) under stressed market conditions, including margin calls resulting from monthly principal payments (that are not remitted to the Company for 20 to 45 days after any given month-end), as well as anticipated declines in the market value of pledged assets and swap positions. In response to deteriorating market conditions, management may reduce the Company's portfolio leverage and therefore increase its liquidity by raising new common and/or preferred equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, management has expanded the number of lending counterparties with whom the Company routinely does business which has further increased the Company's financial flexibility to address challenging market conditions.

**Table of Contents****RESULTS OF OPERATIONS**

|  | <i>Quarter Ended<br/>June 30</i> |             | <i>Six Months<br/>Ended June 30</i> |             |
|--|----------------------------------|-------------|-------------------------------------|-------------|
|  | <i>2011</i>                      | <i>2010</i> | <i>2011</i>                         | <i>2010</i> |
| <b>Income statement data: (dollars in thousands, except per share data)</b>                        |                                  |             |                                     |             |
| Interest income:   |                                  |             |                                     |             |
| Mortgage securities and similar investments  | \$ 63,136                        | \$ 47,634   | \$ 116,277                          | \$ 107,784  |
| Other  | 58                               | 135         | 171                                 | 227         |
|  | 63,194                           | 47,769      | 116,448                             | 108,011     |
| Interest expense:  |                                  |             |                                     |             |
| Repurchase arrangements and similar borrowings   | (13,706)                         | (11,146)    | (26,028)                            | (24,514)    |
| Unsecured borrowings   | (2,187)                          | (2,187)     | (4,374)                             | (4,374)     |
| Other  | (1)                              |             | (5)                                 |             |
|  | (15,894)                         | (13,333)    | (30,407)                            | (28,888)    |
|  | 47,300                           | 34,436      | 86,041                              | 79,123      |
| Other revenue (expense):   |                                  |             |                                     |             |
| Miscellaneous other revenue (expense)  | (599)                            | (98)        | (817)                               | (303)       |
| Incentive compensation   | (1,487)                          | (1,330)     | (2,720)                             | (2,745)     |
| Salaries and benefits  | (1,672)                          | (1,463)     | (3,373)                             | (3,106)     |
| Other general and administrative expense   | (1,066)                          | (1,851)     | (2,028)                             | (2,903)     |
|  | (4,824)                          | (4,742)     | (8,938)                             | (9,057)     |
|  | 42,476                           | 29,694      | 77,103                              | 70,066      |
| Equity in earnings of unconsolidated affiliates  | 65                               | 65          | 130                                 | 130         |
| Net income   | \$ 42,541                        | \$ 29,759   | \$ 77,233                           | \$ 70,196   |
| Diluted earnings per common share  | \$0.48                           | \$0.35      | \$0.90                              | \$0.86      |
| Average diluted shares outstanding   | 77,560                           | 70,072      | 74,575                              | 69,716      |
| <b>Key operating statistics: (dollars in millions)</b>   |                                  |             |                                     |             |
| Weighted average yields:   |                                  |             |                                     |             |
| Mortgage securities and similar investments  | 2.38%                            | 2.55%       | 2.37%                               | 2.83%       |
| Other interest-earning assets  | 0.12                             | 0.19        | 0.16                                | 0.16        |
| Total weighted average yields  | 2.34                             | 2.47        | 2.32                                | 2.73        |
| Weighted average borrowing rates:  |                                  |             |                                     |             |
| Repurchase arrangements and similar borrowings, as adjusted for interest rate hedging transactions | 0.55                             | 0.64        | 0.57                                | 0.69        |
| Unsecured borrowings   | 8.49                             | 8.49        | 8.49                                | 8.49        |
| Other  | 0.10                             |             | 0.14                                |             |
| Total weighted average borrowing rates   | 0.64                             | 0.76        | 0.66                                | 0.80        |
| Total weighted average financing spreads   | 1.70                             | 1.71        | 1.66                                | 1.93        |
| Net yield on total interest-earning assets   | 1.76                             | 1.78        | 1.73                                | 2.02        |

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|   |          |         |         |         |
|---|----------|---------|---------|---------|
| Average total runoff rate ( <i>scheduled payments and prepayments</i> )   | 17.06    | 37.86   | 18.47   | 34.83   |
| Information on average balances:  |          |         |         |         |
| Mortgage securities and similar investments   | \$10,602 | \$7,460 | \$9,802 | \$7,619 |
| Other interest-earning assets   | 196      | 285     | 216     | 289     |
| Repurchase arrangements and similar borrowings  | 9,802    | 6,895   | 9,059   | 7,065   |
| Currently-paying swap agreements ( <i>notional amount</i> )   | 3,618    | 2,800   | 3,351   | 2,827   |
| Unsecured borrowings ( <i>included in long-term investment capital</i> )  | 103      | 103     | 103     | 103     |
| Other interest-bearing liabilities  | 3        |         | 7       |         |
| Long-term investment capital  | 1,254    | 1,124   | 1,206   | 1,123   |
| Portfolio leverage  | 7.82:1   | 6.13:1  | 7.51:1  | 6.29:1  |
| General and administrative and incentive compensation expense as a percentage of average long-term investment capital |          |         |         |         |
|   | 1.35%    | 1.34%   | 1.36%   | 1.38%   |
| Return on average long-term investment capital  | 14.29    | 11.38   | 13.62   | 13.36   |

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Capstead's net income totaled \$43 million and \$77 million or \$0.48 and \$0.90 per diluted common share for the quarter and six months ended June 30, 2011, respectively, compared to \$30 million and \$70 million or \$0.35 and \$0.86 per diluted common share for the same periods in 2010. The increase in earnings can largely be attributed to increased portfolio and leverage levels during 2011. Lower financing spreads in 2011 reflect the effects on portfolio yields of ARM loan coupon interest rates underlying the existing portfolio continuing to reset lower to more current rates. This reflects the relatively low interest rate environment experienced over the last several years. Additionally, portfolio yields have been affected by higher pricing for portfolio acquisitions than prevalent in past years, which has increased the ratio of the Company's portfolio basis to related unpaid principal balances to 102.60 at June 30, 2011 from 102.04 at December 31, 2010 and 101.40 at December 31, 2009. Investment premiums are amortized to earnings as yield adjustments as the portfolio prepays. These factors more than offset the benefits to financing spreads of lower borrowing costs and lower mortgage prepayment rates experienced during 2011.

Yields on interest-earning assets averaged 13 and 41 basis points lower during the quarter and six months ended June 30, 2011 compared to the same periods in 2010 for the reasons noted above. Total portfolio runoff averaged 17.1% and 18.5% on an annualized basis during the quarter and six months ended June 30, 2011 (a 14.6% and 16.0% constant prepayment rate), compared to 37.9% and 34.8% (a 36.2% and 32.3% constant prepayment rate) during the same periods in 2010. Lower current year prepays reflect that the GSEs largely completed buyouts of a backlog of seriously delinquent loans in 2010. Additionally, because the Company's portfolio consists primarily of well-seasoned current-reset ARM securities, relatively few borrowers can take advantage of low current mortgage interest rates because of low housing prices and credit problems being experienced by many of these borrowers.

Borrowing rates on interest-bearing liabilities averaged 12 and 14 basis points lower during the quarter and six months ended June 30, 2011 than during the same periods in 2010 reflecting lower prevailing short-term interest rates, as well as lower rates on interest rate swap positions. Borrowing rates on approximately \$3.62 billion and \$3.35 billion of the Company's average borrowings during the quarter and six months ended June 30, 2011, respectively, were effectively fixed through the use of interest rate swap agreements. The corresponding amount for the same periods in 2010 was \$2.80 billion and \$2.83 billion. Fixed-rate payment requirements on the Company's currently-paying swap positions averaged 1.03% and 1.05% during the quarter and six months ended June 30, 2011 compared to 1.34% and 1.43% during the same periods in 2010. Lower fixed-rate payment requirements on these positions in 2011 reflect the expiration of \$1.50 billion notional amount of relatively high-cost swap agreements since the beginning of 2010. The Company's borrowings under repurchase arrangements typically reset in rate every 30 to 90 days as they are re-established at prevailing rates corresponding to the terms of the borrowings. Rates on these borrowings averaged 0.25% and 0.27% during the quarter and six months ended June 30, 2011 compared to 0.26% and 0.25% during the same periods in 2010.

Miscellaneous other revenue (expense) includes a \$470,000 impairment charge recorded in June 2011 to reduce the Company's remaining investment in two townhome developments to less than \$4 million at June 30, 2011. The charge reflects slow unit sales and poor housing market conditions. Incentive compensation reflects results under a performance-based employee incentive compensation program that provides for a participation in annual earnings, in excess of a benchmark amount and caps annual incentive compensation at 50 basis points multiplied by average long-term investment capital, as defined under this program. The 2011 accruals reflect increases in current year earnings and average long-term investment capital, largely offset by an adjustment made for 2011 to raise the benchmark return threshold from 8% to 10%. See

NOTE 10 to the accompanying consolidated financial statements for additional information regarding the Company's compensation programs. Other general and administrative expenses are lower in 2011 compared to the same periods in 2010 which included over \$1 million in legal and other costs associated with curtailed efforts to enhance recovery prospects for the Company's written-off Nevis investment.

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**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

Capstead's primary sources of funds are borrowings under repurchase arrangements and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity available under its borrowing arrangements is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under Financial Condition Utilization of Long-term Investment Capital and Potential Liquidity and accompanying discussion illustrates management's estimate of additional funds potentially available to the Company as of June 30, 2011 and the Company's perspective on the appropriate level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments when considered appropriate, repayments on borrowings and the payment of cash dividends as required for Capstead's continued qualification as a REIT. It is the Company's policy to remain strongly capitalized and conservatively leveraged.

Capstead has expanded the number of lending counterparties it routinely does business with in order to support larger holdings of residential mortgage investments and to increase its financial flexibility and ability to withstand periods of contracting market liquidity. The Company has uncommitted repurchase facilities with a variety of lending counterparties to finance its portfolio, subject to certain conditions, and had borrowings outstanding with 24 of these counterparties at June 30, 2011. Interest rates on borrowings under repurchase arrangements are generally based on prevailing rates at inception corresponding to the terms of the borrowings. All terms and conditions are negotiated on a transaction-by-transaction basis. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Borrowings under repurchase arrangements secured by residential mortgage investments increased to \$10.44 billion at June 30, 2011, primarily with original maturities of 30 to 120 days. Total borrowings under repurchase arrangements began the year at \$7.79 billion, ended the first quarter at \$9.13 billion and averaged \$8.30 billion and \$9.80 billion during the quarters ended March 31 and June 30, 2011, respectively. Average borrowings during 2011 were lower than at the indicated quarter-ends primarily due to portfolio growth and differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to higher short-term interest rates, Capstead uses currently-paying and forward-starting, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that typically require interest payments for two-year terms. Additionally, in 2010 the Company entered into \$100 million notional amount of forward-starting three-month LIBOR-indexed, swap agreements with fixed rate interest payment requirements averaging 4.09% and 20-year terms coinciding with the floating-rate terms of the Company's long-term unsecured borrowings that begin in 2015 and 2016. These swaps have effectively locked in fixed rates averaging 7.56% (compared to current fixed rates of 8.49%) for the final 20 years of these borrowings that mature in 2035 and 2036. At June 30, 2011 currently-paying swap agreements entered into by the Company had notional amounts totaling \$4.10 billion with average remaining interest payment terms of 12 months and were designated as cash flow hedges for accounting purposes of a like amount of the Company's 30- to 90-day borrowings under repurchase arrangements. Additionally, at June 30, 2011 the Company held forward-starting swap agreements for this purpose with notional amounts totaling \$800 million that begin two-year interest payment terms in August through November 2011. The Company intends to continue to manage interest rate risk by utilizing suitable derivative financial instruments such as interest rate swap agreements.

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During the six months ended June 30, 2011 the Company raised \$143 million in new common equity capital after underwriting discounts and offering expenses through its at-the-market, continuous offering program and has raised additional capital under this program subsequent to quarter-end. Additionally, in June 2011 the Company expanded this program to begin issuing shares of its Series B Preferred stock. The Company may raise additional investment capital in future periods while maintaining a disciplined approach to augmenting its capital base, focusing on transactions that are accretive to existing common stockholders and providing the proceeds can be deployed at attractive levels.

**Interest Rate Sensitivity on Operating Results**

Capstead performs income sensitivity analyses using an income simulation model to estimate the effects that specific interest rate changes can reasonably be expected to have on future earnings. All investments, borrowings and derivative financial instruments held are included in these analyses. The sensitivity of components of other revenue (expense) to changes in interest rates is included as well, although no asset sales are assumed. The model incorporates management's assumptions regarding the level of mortgage prepayments for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity.

Income simulation modeling is the primary tool used by management to assess the direction and magnitude of changes in earnings resulting solely from changes in interest rates. Key assumptions in the model include mortgage prepayment rates, adequate levels of market liquidity, changes in market conditions, portfolio leverage levels, and management's investment capital plans. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate the impact of higher or lower interest rates on earnings. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and other changes in market conditions, management strategies and other factors. Capstead had the following estimated income sensitivity profile at June 30, 2011 and December 31, 2010, respectively (dollars in thousands):

|                                      | <i>Federal<br/>Funds<br/>Rate</i> | <i>10-year U.S.<br/>Treasury<br/>Rate</i> | <i>Immediate Change In Indicated Rates:*</i> |             |             |             |             |
|--------------------------------------|-----------------------------------|---|--|-------------|-------------|-------------|-------------|
|                                      |                                   |   | Up   | Up          | Up          | Up          |             |
| 30-day to one-year rates             |                                   | Flat                                      | 1.00%  | 1.00%       | 2.00%       | 3.00%       |             |
|                                      |                                   | Down                                      |  | Up          | Up          | Up          |             |
| 10-year U.S. Treasury rate           |                                   | 1.00%                                     | Flat   | 1.00%       | 2.00%       | 3.00%       |             |
| Projected 12-month<br>income change: |                                   |   |  |             |             |             |             |
| June 30, 2011                        | <0.25%                            | 3.16%                                     | \$ (8,300)                                   | \$ (24,800) | \$ (21,200) | \$ (47,100) | \$ (87,600) |
| December 31, 2010                    | <0.25                             | 3.30                                      | (5,400)                                      | (13,600)    | (11,400)    | (24,800)    | (49,600)    |

\* Sensitivity of income to changes in interest rates is determined relative to the actual rates at the applicable date. Note that the projected 12-month income change is predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices or if investments made will behave in the same fashion as assets currently held.

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**Table of Contents****RISK FACTORS**

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

***Risks Related to Capstead's Business***

*Potential changes in the relationship between the federal government and the GSEs could negatively affect Capstead's financial condition and earnings. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest on these securities are guaranteed by the GSEs, or by an agency of the federal government, Ginnie Mae. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. The high actual or perceived credit quality of Agency Securities allows the Company to finance its portfolio using repurchase arrangements with relatively low interest rate terms and margin requirements that otherwise would not be available. As a result of deteriorating housing market conditions that began in 2007, the GSEs have incurred substantial losses due to high levels of mortgagor defaults, which are ongoing. In response, in 2008 the Federal Housing Finance Agency placed the GSEs into conservatorship, allowing it to operate the GSEs without forcing them to liquidate. Additionally, the federal government, through the U.S. Treasury and the Federal Reserve, undertook other actions to provide financial support to these entities and the housing market including committing to ensure the GSEs maintain a positive net worth through 2012 through the purchase of preferred stock, and the acquisition by March 2010 of \$1.25 trillion in Agency Securities. These and other steps taken by the federal government were designed to support market stability and mortgage availability by providing additional confidence to investors in Agency Securities. There can be no assurance that the federal government's support for the GSEs and the market for Agency Securities will be adequate to achieve these goals.*

*It is anticipated that over the next several years U.S. policy makers will address what the long-term role of the federal government in general, and the GSEs in particular, will play in the housing markets. The actual or perceived credit quality of Agency Securities could be negatively affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Ginnie Mae, the GSEs or their successors could negatively affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of Agency Securities remains viable, which could negatively affect earnings and book value per common share. In addition, the timing of any sales of Agency Securities held by the Federal Reserve or the GSEs could create volatility in the market pricing of these investments, which could negatively affect book value per common share.*

*A downgrading of the federal government's credit rating and/or the failure of lawmakers to reach agreements on increasing the national debt ceiling or reducing future federal budget deficits could negatively impact Capstead's liquidity, financial condition and earnings. The current national debt ceiling and federal budget deficit concerns have increased the possibility of the credit rating agencies downgrading the federal government's credit rating for the first time in history. Because the GSEs are relying on federal government support, if the federal government's credit rating is downgraded it could impact the perception of credit risk associated with Agency Securities and, therefore, the value of the Company's holdings of Agency Securities. In addition, a downgrade of the federal government's credit*

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rating could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability of borrowings under repurchase arrangements at reasonable terms. As a result, such a default could negatively impact the Company's liquidity, financial condition and earnings.

In the event lawmakers fail to reach agreements on increasing the national debt ceiling or reducing future federal budget deficits, the federal government could default on its obligations, which could negatively impact the trading markets for U.S. Treasury securities and Agency Securities and limit the availability of borrowings under repurchase arrangements at reasonable terms. As a result, such a default could negatively impact the Company's liquidity, financial condition and earnings.

*Legislative and regulatory actions by the federal government could negatively affect the availability or terms of financing using repurchase arrangements.* In July 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank) in order to restrict certain business practices of systemically significant participants in the financial markets, which include most of the Company's lending counterparties. Additionally, Dodd Frank places restrictions on residential mortgage loan originations and reforms the asset-backed securitization markets most notably by imposing credit risk retention requirements. Many of the regulations to implement the provisions of Dodd Frank have yet to be released so it is unclear how significant of an impact the act will have on the financial markets in general and on the Company's strategy of holding a leveraged portfolio of Agency Securities. However, it is possible that the availability or terms of financing using repurchase arrangements could be negatively affected.

*Government-supported mortgagor relief programs could negatively affect Capstead's financial condition and earnings.* U.S. policy makers have established programs designed to provide qualified homeowners with assistance in avoiding foreclosure or in qualifying for the refinancing of their existing mortgages. These programs typically entail the pay off of existing mortgages with any losses absorbed by the GSEs. These mortgagor relief programs, as well as any future legislative or regulatory actions, could significantly reduce the expected life of the Company's residential mortgage investments; therefore, actual yields the Company realizes on these investments could be lower due to faster amortization of investment premiums. Additionally, book value per common share can be adversely affected when relatively high coupon mortgage securities that typically have higher valuations prepay.

*An increase in prepayments may adversely affect Capstead's earnings and book value per common share.* When short- and long-term interest rates are at nearly the same levels (i.e., a flat yield curve environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums, which could adversely affect earnings. Additionally, book value per common share can be adversely affected when relatively high coupon mortgage securities that typically are more prone to default and have higher valuations prepay.

*Changes in interest rates, whether increases or decreases, may adversely affect Capstead's earnings.* Capstead's earnings currently depend primarily on the difference between the interest received on its mortgage securities and similar investments and the interest paid on its related borrowings. The Company typically finances its investments at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on related borrowings not hedged through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising

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short-term interest rate environment. This can contribute to lower or even negative financing spreads and adversely affect earnings. At other times, during periods of relatively low short-term interest rates, declines in the indices used to determine coupon interest rate resets for ARM loans may negatively affect yields on the Company's ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company's borrowing rates, earnings would be adversely affected.

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

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

*Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to the Company or the amounts individual counterparties are willing to lend via repurchase arrangements.* Capstead will generally pledge its investments in mortgage securities as collateral under uncommitted repurchase arrangements with numerous commercial banks and other financial institutions, routinely with maturities of 30 to 90 days. The Company's ability to achieve its investment objectives depends on its ability to re-establish or roll maturing borrowings on a continuous basis. If a counterparty chooses not to roll a maturing borrowing, the Company must pay off the borrowing, generally with cash available from another repurchase arrangement entered into with another counterparty. If the Company determines that it does not have sufficient borrowing capacity with its counterparties, it could be forced to reduce its portfolio leverage by selling assets under potentially adverse market conditions, resulting in losses. This risk is increased if Capstead relies significantly on any single counterparty for a significant portion of its repurchase arrangements. Under these conditions, the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

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*Periods of rising interest rates may reduce amounts available to be borrowed under Capstead's repurchase arrangements due to declines in the perceived fair value of related collateral, which could negatively impact the Company's financial condition and earnings.* Because rising interest rates tend to put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods. Additionally lenders typically determine what fair value is assigned to collateral for margin call purposes, which can diverge from the Company's perspective of fair value during stressed market conditions. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

*If Capstead is unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of the Company's counterparties, the Company's financial condition and earnings could be negatively impacted.* The terms and conditions of each repurchase arrangement are negotiated on a transaction-by-transaction basis, and these borrowings generally are re-established, or rolled, at maturity. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on its future repurchase arrangements. 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 margin requirements be increased. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

*Capstead's use of repurchase arrangements to finance its investments may give the Company's lenders greater rights in the event of bankruptcy.* Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy and subject the Company to losses. In addition, if the Company ever files for bankruptcy, its repurchase arrangement counterparties may be able to avoid the automatic stay provisions of the U.S. Bankruptcy Code and take possession of, and liquidate, the Company's collateral under these arrangements without delay, which could result in losses.

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

*Capstead may invest in derivative financial instruments such as interest rate swap agreements to mitigate or hedge the Company's interest rate risk, which may negatively affect the Company's liquidity, financial condition or earnings.* The Company may invest in such instruments from time to time with the goal of achieving more stable borrowing costs and enhancing the Company's financial condition. However, these activities may not have the desired beneficial impact on the Company's liquidity, financial condition or earnings. For instance, the pricing of ARM securities and the pricing of related derivatives may deteriorate at the same time leading to margin calls by counterparties to both the borrowings supporting investments in ARM securities and the derivatives, negatively impacting the Company's liquidity and financial condition. In addition, counterparties could fail to honor their commitments under the terms of the derivatives or have their credit quality downgraded impairing the value of the derivatives. In the event of any defaults by counterparties, the Company may have difficulty recovering its collateral and may not receive payments provided for under the terms of the derivatives. Should Capstead be required

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to sell its derivatives under such circumstances, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

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

*Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects.* As a self-managed REIT with fewer than 20 employees, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. Although the Company's named executive officers and many of its other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

*Capstead's remaining commercial real estate investments may expose investors to loss* Capstead's remaining commercial real estate investments consist of loans secured by two townhome development properties. The Company consolidates these townhome properties for accounting purposes. Recovery of the Company's investment is dependent upon the sale of remaining townhome units for adequate consideration. Cash flows from unit sales may not be sufficient to cover ongoing operating expenses and recover all of the Company's investments resulting in losses.

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

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

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

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

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

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

will be required to pay tax on any undistributed REIT taxable income,

may be subject to the alternative minimum tax on any tax preference items, and

may operate taxable REIT subsidiaries subject to tax on any taxable income earned.

*Complying with REIT requirements may limit Capstead's ability to hedge effectively.* The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from qualified hedges entered into prior to July 31, 2008, together with any other income not generated from qualified real estate assets, to no more than 25% of gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect its profitability. If the Company fails to satisfy the REIT gross income tests it could lose its REIT status for federal income tax purposes unless the failure was due to reasonable cause and not due to willful neglect.

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

*Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments.* To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of the Company's investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of the Company's assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 20% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

*Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders.* As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal

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

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

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

### ***Risk Factors Related to Capstead's Corporate Structure***

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

*Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations.* The Investment Company Act of 1940 (the "40 Act") exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the 40 Act. If the Company were to be regulated as an investment company, its ability to use leverage would be substantially reduced and it would be unable to conduct business as described in this filing.

The staff of the Securities and Exchange Commission ("SEC") has interpreted the provisions of the 40 Act to generally require REITs that invest primarily in Agency Securities such as Capstead to maintain at least 55% of its assets directly in qualifying real estate interests in order to be exempt from regulation as an investment company. To constitute a qualifying real estate interest under this 55% requirement, a real estate interest must meet various criteria. In satisfying this 55% requirement, the Company may treat mortgage securities issued with respect to an underlying pool to which it holds all issued certificates as qualifying real estate interests. Mortgage securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as securities separate from the underlying

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mortgage loans and, thus, may not qualify for purposes of the 55% requirement. If the SEC or its staff adopts a contrary interpretation of the 40 Act, in order to avoid being regulated as an investment company the Company could be required to sell a substantial amount of its securities or other non-qualified assets under potentially adverse market conditions which could result in losses.

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

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

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

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

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

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

*Redemption Rights:* The Company's preferred shares are redeemable by the Company, in whole or in part, at any time at cash redemption prices (\$16.40 and \$12.50 per share, respectively, for the Series A and B preferred shares) plus all accrued and unpaid dividends to the date of redemption, which may be less than prevailing market prices for these securities.

*Limited Conversion Rights:* Holders of the Company's existing preferred shares may convert into common shares at any time; however, it may not be advantageous to do so given existing conversion ratios and current trading levels of the Company's common shares.

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

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

*Limited Voting Rights:* Voting rights as a holder of existing preferred shares are limited. The Company's common stock is currently the only class of stock carrying full voting rights. Voting rights for holders of existing preferred shares exist primarily with respect to (i) adverse changes in the terms of the existing preferred shares, (ii) the creation of additional classes or series of preferred stock that are senior to the existing preferred shares, (iii) any failure to pay dividends on the existing preferred shares, and (iv) for the Series B Preferred Stock only and provided at least 5.9 million of these preferred shares remain outstanding, the sale of all or substantially all of the Company's assets.

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

### **CRITICAL ACCOUNTING POLICIES**

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

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

*Amortization of Investment Premiums on Financial Assets* Investment premiums on financial assets are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. For most of Capstead's financial assets, estimates and judgments related to future levels of mortgage prepayments are critical to this determination. Mortgage prepayment expectations can vary considerably from period to period based on current and projected changes in interest rates and other factors such as portfolio composition. Management estimates mortgage prepayments based on past experiences with specific investments

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within the portfolio, and current market expectations for changes in interest rates and the residential mortgage lending environment. Should actual prepayment rates differ materially from these estimates, investment premiums would be expensed at a different pace.

*Fair Value and Impairment Accounting for Financial Assets* Most of Capstead's investments are financial assets held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in *Stockholders' equity* as a component of *Accumulated other comprehensive income*. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions. Considerable judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 8 to the consolidated financial statements (included under ITEM 1 of this report) for discussion of how Capstead values its financial assets. Generally, gains or losses are recognized in earnings only if sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of *Other revenue (expense)* if the decline was credit-related or it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary impairment of a mortgage security due to other factors would be recognized in *Accumulated other comprehensive income* and amortized to earnings as a yield adjustment.

Considerable judgment is also required in determining whether an impairment charge should be recognized on an investment in an unsecured loan. The amount of any such impairment, regardless of whether it arose due to credit issues or other factors, would be recognized in earnings as a component of *Other revenue (expense)*. The amount of such charge would be determined by estimating expected future cash flows discounted at market rates.

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

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

The Company currently uses interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of its current and anticipated future 30- and 90-day borrowings and the 20-year, floating-rate periods of the Company's long-term unsecured borrowings. Variable-rate payments to be received on the swap agreements and any measured

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hedge ineffectiveness are recorded in interest expense as an offset to interest owed on the hedged borrowings that reset to market rates generally on a monthly basis while fixed rate swap payments to be made are also recorded in interest expense resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTES 6 and 7 to the consolidated financial statements and Financial Conditions Residential Mortgage Investments for additional information regarding the Company's current use of Derivatives and its related risk management policies.

**CAUTIONARY STATEMENT CONCERNING FORWARD LOOKING STATEMENTS**

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

changes in general economic conditions;

fluctuations in interest rates and levels of mortgage prepayments;

the effectiveness of risk management strategies;

the impact of differing levels of leverage employed;

liquidity of secondary markets and credit markets;

the availability of financing at reasonable levels and terms to support investing on a leveraged basis;

the availability of new investment capital;

the availability of suitable qualifying investments from both an investment return and regulatory perspective;

changes in legislation or regulation affecting the GSEs and similar federal government agencies and related guarantees; and

increases in costs and other general competitive factors.

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



**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS**

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

**ITEM 4. CONTROLS AND PROCEDURES**

As of June 30, 2011, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2011. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to June 30, 2011.

**PART II. OTHER INFORMATION****ITEM 6. EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>DESCRIPTION</b>   |
|---------------------------|--|
| 3.1                       | Charter, including Articles of Incorporation, Articles Supplementary for each series of preferred shares and all other amendments to such Articles of Incorporation. <sup>(1)</sup>  |
| 3.2                       | Amended and Restated Bylaws. <sup>(8)</sup>  |
| 3.3                       | Articles of Amendment of Articles of Incorporation of the Registrant dated as of May 29, 2008. <sup>(11)</sup>   |
| 10.01                     | Amended Restated Deferred Compensation Plan. <sup>(9)</sup>  |
| 10.02                     | Amended and Restated 2004 Flexible Long-Term Incentive Plan. <sup>(2)</sup>  |
| 10.03                     | Second Amended and Restated Incentive Bonus Plan. <sup>(14)</sup>  |
| 10.04                     | Forms of nonqualified stock option and restricted stock agreements for non-employee directors. <sup>(3)</sup>  |
| 10.05                     | Forms of nonqualified stock option and stock award agreements for employees with service conditions. <sup>(6)</sup>  |
| 10.06                     | Nonqualified stock option and stock award agreements for non-employee directors and named executives. <sup>(3)</sup>   |
| 10.07                     | Form of stock award agreements for employees with performance conditions granted in 2008 and 2009. <sup>(12)</sup>   |
| 10.08                     | Form of stock award agreements for employees with performance conditions and deferral of dividends. <sup>(13)</sup>  |
| 10.09                     | Purchase Agreement dated September 23, 2005, by and among the Registrant, the Trust, Merrill Lynch International and Bear, Stearns & Co., Inc. pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(4)</sup>  |
| 10.10                     | Junior Subordinated Indenture dated September 26, 2005, between the Registrant and Wells Fargo Bank pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(4)</sup>   |
| 10.11                     | Amended and Restated Trust Agreement dated September 26, 2005, by and among the Registrant, Wells Fargo Bank, National Association, Wells Fargo Delaware Trust Company, the Administrators and the several Holders, as defined therein, pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(6)</sup> |
| 10.12                     | Placement Agreement dated December 6, 2005, by and among the Registrant, the Trust, FTN Financial Capital Markets and Keefe, Bruyette & Woods, Inc. pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(5)</sup>  |

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|-------|--|
| 10.13 | Indenture dated December 15, 2005, between the Registrant and Wilmington Trust Company regarding junior subordinated debentures due 2035, including a form of debenture pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(6)</sup>  |
| 10.14 | Amended and Restated Declaration of Trust dated December 15, 2005, by and among the Registrant, Wilmington Trust Company and the Administrators defined therein, including forms of capital security certificates pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(6)</sup>    |
| 10.15 | Placement Agreement dated September 8, 2006, by and among the Registrant, the Capstead Mortgage Trust III, FTN Financial Capital Markets and Keefe, Bruyette & Woods, Inc. pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(10)</sup>   |
| 10.16 | Indenture dated September 11, 2006, between the Registrant and Wilmington Trust Company regarding junior subordinated debentures due 2036, including a form of debenture pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(10)</sup>   |
| 10.17 | Amended and Restated Declaration of Trust dated September 11, 2006, by and among the Registrant, Wilmington Trust Company and the Administrators defined therein, including forms of capital security certificates pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(10)</sup> |
| 12    | Computation of ratio of income from continuing operations to combined fixed charges and preferred stock dividends.*  |
| 31.1  | Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*  |
| 31.2  | Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*  |
| 32    | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*   |

Pursuant to applicable SEC rules, the Company will file, no later than 30 days after the date of the filing of this Quarterly Report, an amendment to this Quarterly Report that will contain the Company's unaudited consolidated financial statements included in this Quarterly Report, submitted in XBRL (eXtensible Business Reporting Language) format.

- (1) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001.
- (2) Incorporated by reference to the Registrant's Registration Statement on Form S-8 (No. 333-142861) dated May 9, 2007.
- (3) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the period ended June 20, 2005.
- (4) Incorporated by reference to the Registrant's Current Report on Form 8-K dated September 30, 2005.
- (5) Incorporated by reference to the Registrant's Current Report on Form 8-K dated December 12, 2005.
- (6) Incorporated by reference to the Registrant's Current Report on Form 8-K dated December 20, 2005.
- (7) Incorporated by reference to the Registrant's Current Report on Form 8-K dated January 4, 2006.
- (8) Incorporated by reference to the Registrant's Current Report on Form 8-K dated January 31, 2006.
- (9) Incorporated by reference to the Registrant's Current Report on Form 8-K dated February 23, 2006.
- (10) Incorporated by reference to the Registrant's Current Report on Form 8-K dated September 8, 2006.
- (11) Incorporated by reference to the Registrant's Current Report on Form 8-K dated June 3, 2008.
- (12) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008.
- (13) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2010.
- (14) Incorporated by reference to the Registrant's Current Report on Form 8-K dated May 4, 2011.

\*Filed herewith

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**SIGNATURES**

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

**CAPSTEAD MORTGAGE CORPORATION**  
**Registrant**

Date: August 1, 2011

By: /s/ ANDREW F. JACOBS  
Andrew F. Jacobs  
President and Chief Executive Officer

Date: August 1, 2011

By: /s/ PHILLIP A. REINSCH  
Phillip A. Reinsch  
Executive Vice President and  
Chief Financial Officer

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