

CAPSTEAD MORTGAGE CORP

Form 10-Q

May 02, 2013

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended: March 31, 2013

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)

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**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

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)

95,559,871 as of May 2, 2013

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**CAPSTEAD MORTGAGE CORPORATION**

**FORM 10-Q**

**FOR THE QUARTER ENDED MARCH 31, 2013**

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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>March 31, 2013</i> <i>(unaudited)</i>	<i>December 31, 2012</i>
<b>Assets:</b>		
Residential mortgage investments(\$13.45 and \$13.45 billion pledged under repurchase arrangements at March 31, 2013 and December 31, 2012, respectively)	\$ 13,854,405	\$ 13,860,158
Cash collateral receivable from interest rate swap counterparties	40,233	49,972
Interest rate swap agreements at fair value	114	169
Cash and cash equivalents	471,510	425,445
Receivables and other assets	120,725	130,402
Investments in unconsolidated affiliates	3,117	3,117
	\$ 14,490,104	\$ 14,469,263
<b>Liabilities:</b>		
Repurchase arrangements and similar borrowings	\$ 12,821,519	\$ 12,784,238
Interest rate swap agreements at fair value	24,763	32,868
Unsecured borrowings	103,095	103,095
Common stock dividend payable	30,349	29,512
Accounts payable and accrued expenses	20,286	22,425
	13,000,012	12,972,138
<b>Stockholders equity:</b>		
Preferred stock \$0.10 par value; 100,000 shares authorized:		
\$1.60 Cumulative Preferred Stock, Series A, 186 shares issued and outstanding (\$3,054 aggregate liquidation preference) at March 31, 2013 and December 31, 2012	2,604	2,604
\$1.26 Cumulative Convertible Preferred Stock, Series B, 16,493 shares issued and outstanding (\$187,692 aggregate liquidation preference) at March 31, 2013 and December 31, 2012	186,388	186,388
Common stock \$0.01 par value; 250,000 shares authorized:		
95,532 and 96,229 shares issued and outstanding at		
March 31, 2013 and December 31, 2012, respectively	955	962
Paid-in capital	1,359,879	1,367,199
Accumulated deficit	(353,852)	(353,938)
Accumulated other comprehensive income	294,118	293,910
	1,490,092	1,497,125
	\$ 14,490,104	\$ 14,469,263

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 March 31</i>	
	<i>2013</i>	<i>2012</i>
<b>Interest income:</b>		
Residential mortgage investments	\$ 58,468	\$ 65,733
Other	112	150
	58,580	65,883
<b>Interest expense:</b>		
Repurchase arrangements and similar borrowings	(18,468)	(14,103)
Unsecured borrowings	(2,187)	(2,187)
	(20,655)	(16,290)
	37,925	49,593
<b>Other revenue (expense):</b>		
Miscellaneous other revenue (expense)	(30)	(169)
Incentive compensation	(351)	(1,538)
Salaries and benefits	(1,610)	(1,827)
Other general and administrative expense	(1,081)	(954)
	(3,072)	(4,488)
<b>Income before equity in earnings of unconsolidated affiliates</b>	<b>34,853</b>	<b>45,105</b>
<b>Equity in earnings of unconsolidated affiliates</b>	<b>65</b>	<b>65</b>
<b>Net income</b>	<b>\$ 34,918</b>	<b>\$ 45,170</b>
<b>Net income available to common stockholders:</b>		
Net income	\$ 34,918	\$ 45,170
Less cash dividends paid on preferred shares	(5,270)	(5,213)
	\$ 29,648	\$ 39,957
<b>Net income per common share:</b>		
Basic	\$ 0.31	\$ 0.45
Diluted	0.31	0.44
<b>Cash dividends declared per share:</b>		
Common	\$ 0.310	\$ 0.430
Series A Preferred	0.400	0.400
Series B Preferred	0.315	0.315

*See accompanying notes to consolidated financial statements.*



**Table of Contents****CAPSTEAD MORTGAGE CORPORATION****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME***(in thousands, unaudited)*

	<i>Quarter Ended March 31</i>	
	<i>2013</i>	<i>2012</i>
<b>Net income</b>	<b>\$ 34,918</b>	<b>\$ 45,170</b>
<b>Other comprehensive income:</b>		
Amounts related to available-for-sale securities:		
Change in net unrealized gains	(7,705)	40,612
Amounts related to cash flow hedges:		
Change in net unrealized losses	2,479	(1,751)
Reclassification adjustment for amounts included in net income	5,434	4,965
	208	43,826
<b>Comprehensive income</b>	<b>\$ 35,126</b>	<b>\$ 88,996</b>

*See accompanying notes to consolidated financial statements.*



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

*(in thousands, unaudited)*

	<i>Quarter Ended March 31</i>	
	<i>2013</i>	<i>2012</i>
<b>Operating activities:</b>		
Net income	\$ 34,918	\$ 45,170
Noncash items:		
Amortization of investment premiums	28,385	18,496
Depreciation and other amortization	47	48
Amortization of equity-based awards	512	549
Change in measureable hedge ineffectiveness related to interest rate swap agreements	(138)	(318)
Net change in receivables, other assets, accounts payable and accrued expenses	(499)	(8,124)
<b>Net cash provided by operating activities</b>	<b>63,225</b>	<b>55,821</b>
<b>Investing activities:</b>		
Purchases of residential mortgage investments	(839,883)	(1,275,570)
Interest receivable acquired with the purchase of residential mortgage investments	(1,495)	(2,169)
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	819,023	550,919
<b>Net cash used in investing activities</b>	<b>(22,355)</b>	<b>(726,820)</b>
<b>Financing activities:</b>		
Proceeds from repurchase arrangements and similar borrowings	34,947,671	32,291,152
Principal payments on repurchase arrangements and similar borrowings	(34,910,386)	(31,558,772)
Decrease in cash collateral receivable from interest rate swap counterparties	9,739	5,625
Common share repurchases	(7,292)	
Other capital stock transactions	(521)	62,913
Dividends paid	(34,016)	(43,064)
<b>Net cash provided by financing activities</b>	<b>5,195</b>	<b>757,854</b>
<b>Net change in cash and cash equivalents</b>	<b>46,065</b>	<b>86,855</b>
Cash and cash equivalents at beginning of period	425,445	426,717
<b>Cash and cash equivalents at end of period</b>	<b>\$ 471,510</b>	<b>\$ 513,572</b>

*See accompanying notes to consolidated financial statements.*

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**CAPSTEAD MORTGAGE CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**MARCH 31, 2013**

*(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. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae, referred to as Agency Securities, are considered to have limited, if any, credit risk.

**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 ended March 31, 2013 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2013. 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, 2012. Certain prior period amounts have been reclassified to conform to the current year presentation. These include reclassification amounts associated with the change in mortgage securities principal remittance receivable for the quarter ended March 31, 2012 that in order to properly present this change has been reclassified from operating activities to investing activities in the Statement of Cash Flows. The effect of this correction decreased cash provided by operating activities and cash used in investing activities by \$786,000 for the three months ended March 31, 2012.

***Recent Accounting Developments***

In December 2011 the FASB issued ASU No. 2011-11, *Disclosures about Offsetting Assets and Liabilities*. In January 2013, the FASB issued ASU No. 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. This guidance is effective for reporting periods beginning on or after January 1, 2013. The Company adopted ASU No. 2011-11 as amended by ASU No. 2013-01 in the current quarter. The provisions of these ASUs had no effect on the Company s results of operations, financial condition, or cash flows.

In February 2013 the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* that amended ASU No. 2011-12 and ASU No. 2011-05. This guidance is effective for reporting periods beginning after December 15, 2012. The Company adopted ASU No. 2013-02 in the current quarter. The provisions of this ASU had no effect on the Company s results of operations, financial condition, or cash flows.

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Basic net income 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 net income 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 net income 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 net income per common share, if dilutive, under either the two class method or the treasury stock method, depending upon which method produces the more dilutive result.

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

	<i>Quarter Ended March 31</i>	
	<i>2013</i>	<i>2012</i>
<b><i>Basic net income per common share</i></b>		
Numerator for basic net income per common share:		
Net income	\$ 34,918	\$ 45,170
Series A and B preferred share dividends	(5,270)	(5,213)
Unvested stock award participation in earnings	(32)	(107)
	\$ 29,616	\$ 39,850
Denominator for basic net income per common share:		
Weighted average common shares outstanding	95,560	89,980
Average unvested stock awards outstanding	(540)	(531)
	95,020	89,449
	\$ 0.31	\$ 0.45
<b><i>Diluted net income per common share</i></b>		
Numerator for diluted net income per common share:		
Net income	\$ 34,918	\$ 45,170
Dividends on antidilutive convertible preferred shares	(5,195)	(5,138)
Unvested stock award participation in earnings	(32)	(107)
	\$ 29,691	\$ 39,925
Denominator for diluted net income per common share:		
Weighted average common shares outstanding	95,560	89,980
Average unvested stock awards outstanding	(540)	(531)
Net effect of dilutive stock and option awards	121	102
Net effect of dilutive convertible preferred shares	309	308
	95,450	89,859
	\$ 0.31	\$ 0.44



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

	<i>Quarter Ended March 31</i>	
	<i>2013</i>	<i>2012</i>
Antidilutive convertible preferred shares	16,493	16,415
Antidilutive equity awards excludable under the treasury stock method:		
Shares issuable under option awards	35	10

**NOTE 4 RESIDENTIAL MORTGAGE INVESTMENTS**

*Residential mortgage investments* classified by collateral type and interest rate characteristics were as follows (dollars in thousands):

	<i>Unpaid Principal Balance</i>	<i>Investment Premiums</i>	<i>Amortized Cost Basis</i>	<i>Carrying Amount <sup>(a)</sup></i>	<i>Net WAC <sup>(b)</sup></i>	<i>Average Yield <sup>(b)</sup></i>
<b>March 31, 2013</b>						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	\$ 2,983	\$ 8	\$ 2,991	\$ 2,995	6.70%	6.49%
ARMs	11,526,720	363,510	11,890,230	12,178,281	2.67	1.70
Ginnie Mae ARMs	1,582,786	49,478	1,632,264	1,662,953	2.70	1.90
	13,112,489	412,996	13,525,485	13,844,229	2.68	1.72
Residential mortgage loans:						
Fixed-rate	2,947	5	2,952	2,952	7.00	5.88
ARMs	4,740	19	4,759	4,759	3.85	3.53
	7,687	24	7,711	7,711	5.05	4.42
Collateral for structured financings	2,425	40	2,465	2,465	8.11	6.80
	\$ 13,122,601	\$ 413,060	\$ 13,535,661	\$ 13,854,405	2.68	1.73
<b>December 31, 2012</b>						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	\$ 3,194	\$ 9	\$ 3,203	\$ 3,208	6.70%	6.47%
ARMs	11,547,954	356,646	11,904,600	12,198,922	2.69	1.72
Ginnie Mae ARMs	1,566,749	48,248	1,614,997	1,647,119	2.77	1.95
	13,117,897	404,903	13,522,800	13,849,249	2.70	1.75
Residential mortgage loans:						
Fixed-rate	3,007	5	3,012	3,012	7.01	6.15
ARMs	5,031	20	5,051	5,051	3.87	3.85
	8,038	25	8,063	8,063	5.04	4.71
Collateral for structured financings	2,799	47	2,846	2,846	8.12	7.57
	\$ 13,128,734	\$ 404,975	\$ 13,533,709	\$ 13,860,158	2.71	1.76

- (a) *Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale (see NOTE 9).*
- (b) *Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments net of servicing and other fees as of the indicated balance sheet date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. Average yield is presented for the quarter then ended, and is based on the cash component of interest income expressed as a percentage calculated on an annualized basis on average amortized cost basis (the cash yield ) less the effects of amortizing investment premiums. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments.*

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Agency Securities are considered to have limited, if any, credit risk, because of federal government support for the GSEs. 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 that were obtained through this mortgage conduit and are pledged to secure repayment of related structured financings. Credit risk for these securities is borne by the related bondholders. The maturity of *Residential mortgage investments* is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 292 months.

Fixed-rate investments consist of residential mortgage loans and Agency Securities backed by residential 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 months to roll of less than 18 months while longer-to-reset ARM securities have months to roll of 18 months or greater. As of March 31, 2013, the average months to roll for the Company's \$7.65 billion (amortized cost basis) in current-reset ARM securities was 5.4 months while the average months-to-roll for the Company's \$5.87 billion (amortized cost basis) in longer-to-reset ARM securities was 42.5 months.

**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 8). 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. Under variable interest accounting rules, the trusts are not considered variable interests at risk and as such are not consolidated.

**NOTE 6 REPURCHASE ARRANGEMENTS AND SIMILAR BORROWINGS**

Capstead generally pledges its Residential mortgage investments as collateral under repurchase arrangements with commercial banks and other financial institutions, referred to as counterparties, the terms and conditions of which are negotiated on a transaction-by-transaction basis when each borrowing is initiated or renewed. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings. 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. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a haircut. 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

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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. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security pay down 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.

*Repurchase arrangements and similar borrowings* (and related pledged collateral, including accrued interest receivable), classified by collateral type and remaining maturities, and related weighted average borrowing rates as of the indicated date were as follows (dollars in thousands):

<i>Collateral Type</i>	<i>Collateral Carrying Amount</i>	<i>Accrued Interest Receivable</i>	<i>Borrowings Outstanding</i>	<i>Average Borrowing Rates</i>
<b>As of March 31, 2013:</b>				
Borrowings with maturities of 30 days or less:				
Agency Securities	\$ 13,304,142	\$ 29,108	\$ 12,679,900	0.40%
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)	146,266	263	139,154	0.45
Similar borrowings:				
Collateral for structured financings*	2,465		2,465	8.11
	\$ 13,452,873	\$ 29,371	\$ 12,821,519	0.40
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments ( Derivatives ) held as cash flow hedges (see NOTE 7)				0.55
<b>As of December 31, 2012:</b>				
Borrowings with maturities of 30 days or less:				
Agency Securities	\$ 13,406,253	\$ 32,807	\$ 12,739,872	0.47%
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)	44,060	51	41,520	0.57
Similar borrowings:				
Collateral for structured financings*	2,846		2,846	8.12
	\$ 13,453,159	\$ 32,858	\$ 12,784,238	0.47
Quarter-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				0.65

\* *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.*

Average borrowings outstanding during the indicated quarters varied from borrowings outstanding at the indicated balance sheet dates due to differences in the timing and amount of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

	<i>Quarter Ended</i>			
	<i>March 31, 2013</i>		<i>December 31, 2012</i>	
	<i>Average Borrowings</i>	<i>Average Rate</i>	<i>Average Borrowings</i>	<i>Average Rate</i>
	\$ 12,769,298	0.58%	\$ 13,228,535	0.63%



Average borrowings and rates for the indicated quarters, adjusted for the effects of related Derivatives held as cash flow hedges

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**Table of Contents****NOTE 7 USE OF DERIVATIVE FINANCIAL INSTRUMENTS, OFFSETTING****DISCLOSURES AND CHANGES IN OTHER COMPREHENSIVE INCOME BY COMPONENT**

To help mitigate exposure to higher short-term interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. 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 hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and actual borrowing rates.

During the first quarter of 2013 Capstead entered into \$800 million notional amount of new forward-starting swap agreements requiring fixed rate interest payments averaging 0.48% for two-year periods beginning on various dates in December 2013 and January 2014. Swap agreements with notional amounts totaling \$1.10 billion requiring fixed rate interest payments averaging 0.81% expired during the quarter, and were replaced with previously acquired swap agreements with notional amounts totaling \$1.10 billion requiring fixed rate interest payments averaging 0.50% for two-year periods. At March 31, 2013, the Company was a party to swap agreements hedging short-term interest rates with the following characteristics (dollars in thousands):

<i>Period of</i>	<i>Notional Amount</i>	<i>Average Fixed Rate Payment Requirement</i>
<b>Contract Expiration</b>		
Currently-paying contracts:		
Second quarter 2013	\$ 700,000	0.96%
Third quarter 2013	300,000	0.87
Fourth quarter 2013	800,000	0.78
First quarter 2014	200,000	0.60
Second quarter 2014	400,000	0.51
Third quarter 2014	200,000	0.51
Fourth quarter 2014	500,000	0.58
First quarter 2015	1,100,000	0.50
(average expiration: 12 months)	4,200,000	0.67
Forward-starting contracts:		
Second quarter 2015	200,000	0.43
Third quarter 2015	400,000	0.47
Fourth quarter 2015	1,200,000	0.45
First quarter 2016	300,000	0.47
(average expiration: 31 months)	2,100,000	0.45
(average expiration: 18 months)	\$ 6,300,000	

In addition to swap agreements hedging short-term interest rates, in 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% that begin in 2015 and 2016, and 20-year payment terms coinciding with the floating-rate terms of the Company's *Unsecured borrowings*. 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 long-term borrowings (see NOTE 8).

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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 future variable cash receipts which are 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 these 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>Balance Sheet Location</i>	<i>March 31, 2013</i>	<i>December 31, 2012</i>
<b>Balance sheet-related</b>			
Interest rate swap agreements in a gain position (an asset) related to:			
Repurchase arrangements and similar borrowings	(a)	\$ 114	\$ 169
Interest rate swap agreements in a loss position (a liability) related to:			
Repurchase arrangements and similar borrowings	(a)	(13,821)	(18,671)
Unsecured borrowings	(a)	(10,942)	(14,197)
Related net interest payable	(b)	(8,490)	(7,788)
		\$ (33,139)	\$ (40,487)

- (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 at March 31, 2013 scheduled to be recognized in the Statement of Income over the next twelve months primarily in the form of fixed-rate swap payments in excess of current market rates totaled \$11.9 million.
- (b) Included in Accounts payable and accrued expenses on the face of the Balance Sheet.

	<i>Location of Gain or (Loss) Recognized in Net Income</i>	<i>Quarter Ended March 31 2013</i>	<i>2012</i>
<b>Income statement-related</b>			
Components of effect on interest expense:			
Amount of loss reclassified from Accumulated other comprehensive income related to the effective portion of active positions		\$ (5,434)	\$ (4,965)
Amount of gain recognized (ineffective portion)		120	141
Increase in interest expense and decrease in Net income as a result of the use of Derivatives	(a)	\$ (5,314)	\$ (4,824)
<b>Other comprehensive income-related:</b>			
Amount of loss recognized in Other comprehensive income (effective portion)		\$ 2,479	\$ (1,751)

- (a) Included in Interest expense: Repurchase arrangements and similar borrowings on the face of the Statement of Income.



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The Company's swap agreements and repurchase arrangements are subject to master netting arrangements in the event of default on, or termination of, any one contract. See NOTE 6 for more information on *Repurchase arrangements and similar borrowings*. Offsetting disclosures for all Derivatives held as well as repurchase arrangements and similar borrowings outstanding were as follows (in thousands):

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Offsetting of Derivative Assets		Cash Collateral Received	Net Amount
			Net Amounts of Assets Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		
<b>As of March 31, 2013:</b>						
Counterparty 1	\$ 95	\$	\$ 95	\$ (95)	\$	\$
Counterparty 2	19		19	(19)		
	\$ 114	\$	\$ 114	\$ (114)	\$	\$
<b>As of December 31, 2012:</b>						
Counterparty 1	\$ 128	\$	\$ 128	\$ (128)	\$	\$
Counterparty 2	41		41	(41)		
	\$ 169	\$	\$ 169	\$ (169)	\$	\$

	Gross Amounts of Recognized Liabilities <sup>(a)</sup>	Gross Amounts Offset in the Balance Sheet	Offsetting of Financial Liabilities and Derivative Liabilities		Cash Collateral Pledged <sup>(b)</sup>	Net Amount
			Net Amounts of Liabilities Presented in the Balance Sheet <sup>(a)</sup>	Gross Amounts Not Offset in the Balance Sheet		
<b>As of March 31, 2013:</b>						
Derivatives by counterparty:						
Counterparty 1	\$ 21,407	\$	\$ 21,407	\$ (95)	\$ (21,312)	\$
Counterparty 2	10,359		10,359	(19)	(9,600)	740
Counterparty 3	1,487		1,487		(1,487)	
	33,253		33,253	(114)	(32,399)	740
Repurchase arrangements and similar borrowings	12,824,944		12,824,944	(12,824,944)		
	\$ 12,858,197	\$	\$ 12,858,197	\$ (12,825,058)	\$ (32,399)	\$ 740
<b>As of December 31, 2012:</b>						
Derivatives by counterparty:						
Counterparty 1	\$ 26,904	\$	\$ 26,904	\$ (128)	\$ (26,776)	\$
Counterparty 2	12,357		12,357	(41)	(11,500)	816
Counterparty 3	1,395		1,395		(1,395)	
	40,656		40,656	(169)	(39,671)	816
Repurchase arrangements and similar borrowings	12,791,243		12,791,243	(12,791,243)		
	\$ 12,831,899	\$	\$ 12,831,899	\$ (12,791,412)	\$ (39,671)	\$ 816

- (a) *Amounts include accrued interest of \$8.5 million and \$7.8 million on interest rate swap agreements and \$3.4 million and \$7.0 million on repurchase arrangements and similar borrowings, included in Accounts payable and accrued expenses on the face of the Balance Sheets as of March 31, 2013 and December 31, 2012, respectively.*
- (b) *Amounts presented are limited to collateral pledged sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.*

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Changes in *Accumulated other comprehensive income* by component for the period ended March 31, 2013 were as follows (in thousands):

	<i>Gains and Losses on Cash Flow Hedges</i>	<i>Unrealized Gains and Losses on Available-for-Sale Securities</i>	<i>Total</i>
Balance at December 31, 2012	\$ (32,539)	\$ 326,449	\$ 293,910
Other comprehensive income before reclassifications	2,479	(7,705)	(5,226)
Amounts reclassified from accumulated other comprehensive income	5,434		5,434
Net current-period other comprehensive income	7,913	(7,705)	208
Balance at March 31, 2013	\$ (24,626)	\$ 318,744	\$ 294,118

**NOTE 8 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 so-called trust preferred securities with unrelated third party investors. Included in *Receivables and other assets* are \$2.3 million in remaining issue costs associated with these transactions at March 31, 2013 and December 31, 2012. Note balances and related weighted average interest rates as of March 31, 2013 and December 31, 2012 (calculated including issue cost amortization) were as follows (dollars in thousands):

	<i>Borrowings Outstanding</i>	<i>Average 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 indicated weighted average rates have been in effect since issuance. After considering cash flow hedges that coincide with the floating rate terms of these borrowings that begin in October and December 2015 for the Capstead Mortgage Trust I and II notes and September 2016 for the Capstead Mortgage Trust III notes, 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.*

The Capstead Mortgage Trust I notes and trust securities mature in October 2035 and are currently redeemable, in whole or in part, without penalty, at the Company's option. 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.

**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, all of which are determined using Level 2 Inputs in accordance with ASC 820, 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.



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*Residential mortgage investments*, nearly all of which are mortgage securities classified as available-for-sale, are measured at fair value on a recurring basis. 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. In determining fair value estimates for longer-term borrowings under repurchase arrangements, if any, the Company considers pricing levels indicated by lenders for entering into new transactions using similar pledged collateral with terms equal to the remaining terms of the longer-term borrowings. In determining fair value estimates for unsecured borrowings, the Company considers current pricing for financial instruments with similar characteristics. 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, which are valued using primarily Level 1 measurements, including *Cash and cash equivalents*, *Cash collateral receivable from interest rate swap counterparties*, receivables, payables and borrowings under repurchase arrangements with initial terms of 120 days or less. See NOTE 7 for information relative to the valuation of interest rate swap agreements.

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

	March 31, 2013		December 31, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets:</b>				
Residential mortgage loans	\$ 7,711	\$ 7,800	\$ 8,063	\$ 8,200
Interest rate swap agreements	114	114	169	169
<b>Financial liabilities:</b>				
Repurchase arrangements with initial terms of greater than 120 days	41,520	41,500	41,520	41,500
Unsecured borrowings	103,095	104,600	103,095	104,600
Interest rate swap agreements	24,763	24,763	32,868	32,868

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

	Amortized Cost Basis	Gross Unrealized		Fair Value
		Gains	Losses	
<b>As of March 31, 2013</b>				
Agency Securities classified as available-for-sale	\$ 13,522,551	\$ 319,249	\$ 505	\$ 13,841,295
Residential mortgage securities classified as held-to-maturity	5,399	285		5,684
<b>As of December 31, 2012</b>				
Agency Securities classified as available-for-sale	\$ 13,519,657	\$ 328,412	\$ 1,963	\$ 13,846,106
Residential mortgage securities classified as held-to-maturity	5,989	309		6,298

	March 31, 2013		December 31, 2012	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Securities in an unrealized loss position:</b>				
One year or greater	\$ 26,806	\$ 96	\$ 29,760	\$ 120
Less than one year	292,582	409	751,645	1,843
	\$ 319,388	\$ 505	\$ 781,405	\$ 1,963

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Capstead's investment strategy involves managing a leveraged portfolio of primarily ARM Agency Securities and management expects these securities will be held until payoff absent a major shift in strategy. 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 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 federal government support for the GSEs, 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, (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 March 31, 2013.

**NOTE 10 COMPENSATION PROGRAMS**

The compensation committee of Capstead's board of directors (the Committee) 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 order to establish a significant variable component to the base compensation of executive officers, the Committee has installed a performance-based cash compensation program to augment base salaries for these officers. This program 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 per share that the Company's common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. Dividend Equivalent Rights issued and outstanding at March 31, 2013 and the related compensation costs for the quarters ended March 31, 2013 and 2012 were as follows:

<i>Month of</i>	<i>Total</i> <i>Grant</i>	<i>Quarter Ended March 31</i>	
		<i>2013</i>	<i>2012</i>
<i>Grant*</i>			
July 2008	225,000	\$ 70,000	\$ 97,000
July 2009	225,000	70,000	97,000
July 2010	60,000	19,000	26,000
August 2011	72,000	22,000	31,000
July 2012	72,000	22,000	
	654,000	\$ 203,000	\$ 251,000

\* All grants expire July 1, 2015 unless extended by the Committee.

***Annual Incentive Compensation***

To provide employees with an appropriate performance-based annual incentive compensation opportunity, each year the Committee approves an incentive formula designed to create an incentive pool to serve as a guideline for the award of annual incentive compensation that is directly linked with the performance of the Company. The formula adopted accomplishes this by establishing an incentive pool equal to a percentage participation in the Company's earnings in excess of a pre-established performance

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threshold or benchmark, subject to a maximum amount, or cap, available to be paid in any one year. Notwithstanding the calculated amount of the incentive pool, the Committee retains discretion to determine (i) the amount actually awarded, (ii) its allocation between executive officers and other employees, and (iii) the form of payment (e.g., cash or equity awards).

The current formula for the incentive pool is based on a 10.0% participation in annual earnings in excess of an amount established by multiplying average long-term investment capital by a benchmark rate equal to the greater of 10.0% or the average 10-year U.S. Treasury rate plus 200 basis points, subject to a cap of 50 basis points multiplied by average long-term investment capital. Annual earnings for formula purposes is defined as *Net income* excluding (i) *Incentive compensation*, (ii) any gains or losses 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 is defined as 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) certain gains or losses from asset sales or writedowns, and (iv) interest accruals on *Unsecured borrowings*. Included in *Accounts payable and accrued expenses* are annual incentive compensation accruals totaling \$351,000 and \$1,538,000 at March 31, 2013 and 2012, respectively.

**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 March 31, 2013, the Plans had 528,018 common shares remaining available for future issuance.

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 on the Company's long-term investment capital, subject to certain adjustments, that must be exceeded for the awards to vest, equal to 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 March 31, 2013:

Year of Grant	Grant Date	Total	Final	Remaining Shares with			
	Fair Value Per Share	Original Grants	Measurement Period Ends December 31	Initial Measurement Periods Ending December 31			
				2013	2014	2015	2016
2008	\$ 10.18	140,658 <sup>(a)</sup>	2015				
2009	14.33	110,917 <sup>(b)</sup>	2016	52,915			
2010	12.44	128,766	2017	61,508	61,499		
2011	12.72	132,490	2018		63,722	63,718	
2012	11.67	145,399	2019			69,853	69,849

(a) The performance criteria for the three-year measurement periods ending December 31, 2012 and 2011 were met resulting in the vesting of 135,194 shares associated with this grant.

(b) The performance criteria for the first three-year measurement period ending December 31, 2012 was met resulting in the vesting of 53,431 shares associated with the first 50% of this grant.

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The following table includes service-based stock awards issued to directors and employees with related vesting and forfeiture information (subject to certain restrictions, principally continuous service), at March 31, 2013:

<i>Year of Grant</i>	<i>Grant Date Fair Value Per Share</i>	<i>Total Original Grants</i>	<i>As of March 31, 2013</i>		<i>Remaining Shares Scheduled to Vest During:</i>	
			<i>Vested</i>	<i>Forfeited</i>	<i>2013*</i>	<i>2014</i>
2007	\$ 12.93	156,000	98,507	12,832	22,497	22,164
2008	12.87	6,000	6,000			
2009	11.39	6,000	6,000			
2010	11.64	12,000	12,000			
2011	13.23	24,000	24,000			
2012	13.59	29,000			29,000	

\* The 2007 grant shares vested in January 2013 and the 2012 grant shares are scheduled to vest in April 2013.

Performance-based and service-based stock award activity for the quarter ended March 31, 2013 is summarized below:

	<i>Number of Shares</i>	<i>Weighted Average Grant Date Fair Value</i>
Unvested stock awards outstanding at December 31, 2012	657,720	\$ 12.48
Vestings	(143,523)	12.17
Forfeitures	(19,969)	12.65
Unvested stock awards outstanding at March 31, 2013	494,228	12.56

During the quarters ended March 31, 2013 and 2012, the Company recognized in *Salaries and benefits* \$406,000 and \$469,000, respectively, related to amortization of the grant date fair value of employee performance-based and service-based stock awards. The amounts amortized for these periods assumed that performance criteria, if applicable, would continue to be met for related initial measurement periods. In addition, the Company recognized in *Other general and administrative expense* \$106,000 and \$80,000 related to amortization of the grant date fair value of service-based director stock awards during the quarters ended March 31, 2013 and 2012, respectively. All service-based stock awards and the 2008 and 2009 performance-based stock awards receive dividends on a current basis without risk of forfeiture if the related awards do not vest. Performance-based awards granted subsequent to 2009 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 March 31, 2013 dividends payable pertaining to these awards totaled \$855,000 and are included in *Common stock dividend payable*. Unrecognized compensation expense for unvested stock awards totaled \$3.9 million as of March 31, 2013, to be expensed over a weighted average period of 1.5 years (assumes minimal employee attrition and applicable performance criteria are met for related initial measurement periods).

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 option awards 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 have been granted since 2010.

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Option award activity for the quarter ended December 31, 2012 is summarized below:

	<i>Number of Shares</i>	<i>Weighted Average Exercise Price</i>
Option awards outstanding at December 31, 2012	97,500	\$ 11.63
Exercises	(3,750)	9.40
Option awards outstanding at March 31, 2013	93,750	11.72

Exercisable option awards outstanding as of March 31, 2013 totaled 93,750 shares with a weighted average remaining contractual term of 4.5 years, an average exercise price of \$11.72 and an aggregate intrinsic value of \$120,000. The total intrinsic value of option awards exercised during the quarter ended March 31, 2013 was \$13,000.

**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 quarters ended March 31, 2013 and 2012, the Company recognized in *Salaries and benefits* \$63,000 and \$133,000 related to contributions to these plans, respectively.

**NOTE 11 NET INTEREST INCOME ANALYSIS**

The following tables summarize 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 March 31</i>				<i>Related Changes in</i>		
	<i>2013</i>		<i>2012</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>							
Residential mortgage investments	\$ 58,468	1.73%	\$ 65,733	2.14%	\$ (13,557)	\$ 6,292	\$ (7,265)
Other	112	0.11	150	0.15	(51)	14	(37)
	58,580	1.68	65,883	2.08	(13,608)	6,306	(7,302)
<b>Interest expense:</b>							
Repurchase arrangements and similar borrowings	(18,468)	0.58	(14,103)	0.49	2,783	1,582	4,365
Unsecured borrowings	(2,187)	8.49	(2,187)	8.49			
	(20,655)	0.64	(16,290)	0.56	2,783	1,582	4,365
	\$ 37,925	1.04	\$ 49,593	1.52	\$ (16,391)	\$ 4,724	\$ (11,667)

\* The change in interest income and interest expense due to both rate and volume has been allocated to rate and volume 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 operates as a self-managed REIT and earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of ARM Agency Securities, which are considered to have limited, if any, credit risk. See NOTE 1 to the accompanying consolidated financial statements for certain definitions of acronyms and terms used herein.

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 March 31, 2013 totaled \$1.59 billion and consisted of \$1.30 billion of common and \$189 million of perpetual preferred stockholders' equity (recorded amounts) and \$100 million of long-term unsecured borrowings (net of related investments in statutory trusts). Long-term investment capital was largely unchanged from year-end reflecting relatively stable ARM security pricing levels. Holdings of ARM Agency Securities decreased \$6 million during the quarter to \$13.85 billion at March 31, 2013, while repurchase arrangements and similar borrowings increased \$37 million to \$12.82 billion. Portfolio leverage (repurchase arrangements and similar borrowings divided by long-term investment capital) increased modestly to 8.06 to one by March 31, 2013 from 8.00 to one at December 31, 2012. Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio of Agency Securities under current market conditions, particularly a portfolio consisting almost entirely of relatively short-duration ARM Agency Securities (duration is a common measure of market price sensitivity to interest rate movements).

Capstead reported net income of \$35 million or \$0.31 per diluted common share for the first quarter of 2013, compared to \$35 million or \$0.31 per diluted common share for the fourth quarter of 2012 and \$45 million or \$0.44 per diluted common share for the first quarter of 2012. Financing spreads on residential mortgage investments averaged 115 basis points for the first quarter of 2013, compared to 113 basis points for the fourth quarter of 2012 and 165 basis points for the first quarter of 2012. Lower financing spreads since first quarter 2012 reflect (a) lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates resetting lower to more current rates as well as lower coupon interest rates on acquisitions, and (b) higher investment premium amortization because of higher levels of mortgage prepayments as well as higher prices paid for portfolio acquisitions in recent years. Even as unhedged borrowing rates for the first quarter of 2013 were lower compared to the fourth quarter of 2012, these rates were higher than rates in effect during the first quarter of 2012 because of changes in market conditions. A portion of this increase was offset by lower rates on currently-paying interest rate swap agreements. Operating costs as a percentage of average long-term investment capital declined two and 42 basis points, respectively, to 77 basis points for the first quarter of 2013 compared to the fourth and first quarters of 2012, primarily reflecting lower performance-based compensation costs.

The size and composition of Capstead's investment portfolio depends on investment strategies being implemented by management, as well as overall market conditions, including the availability of attractively priced investments and suitable financing to 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.

**Table of Contents*****Common Share Repurchases***

In late 2012 the Company implemented a \$100 million common share repurchase program and suspended its continuous offering program until further notice. Purchases made pursuant to the common share repurchase program can be made in the open market or through privately negotiated transactions from time to time as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any repurchases are determined by the Company in its discretion and are subject to economic and market conditions, share price, applicable legal requirements and other factors. Pursuant to this authorization, in November and December 2012 repurchases totaled 3.0 million common shares at an average cost of \$11.80 per share for \$35 million. An additional 638,000 shares were repurchased in early January 2013 at an average cost of \$11.43 per share for \$7 million. No further repurchases have been made since January, leaving \$58 million of the authorization available for future repurchases. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. Upon suspension of the repurchase program, issuances of common shares under the continuous offering program or by other means may resume subject to compliance with federal securities laws, 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***

All but \$13 million of Capstead's \$13.85 billion of residential mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company's balance sheet and 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 investments 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 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 containing a significant amount of non-agency and/or fixed-rate mortgage securities. The following table illustrates the progression of the Company's book value per common share for the quarter ended March 31, 2013:

Book value per common share, beginning of quarter	\$ 13.58
Capital transactions:	
Accretion from common share repurchases	0.01
Increase related to stock awards	0.01
Decrease in unrealized gains on mortgage securities classified as available-for-sale	(0.08)
Decrease in unrealized losses on interest rate swap agreements designated as cash flow hedges of:	
Repurchase arrangements and similar borrowings	0.05
Unsecured borrowings	0.03
Book value per common share, end of quarter	\$ 13.60
Increase in book value per common share during the quarter	\$ 0.02



**Table of Contents****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 Ginnie Mae, which is an agency of the federal government. Federal government support for the GSEs has 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 short-term interest rates. The following table illustrates the progression of the Company's portfolio of residential mortgage investments for the quarter ended March 31, 2013 (in thousands):

Residential mortgage investments, beginning of quarter	\$ 13,860,158
Decrease in unrealized gains on mortgage securities classified as available-for-sale	(7,705)
Portfolio acquisitions (principal amount) at average lifetime purchased yields of 2.09%	803,409
Investment premiums on acquisitions*	36,474
Portfolio runoff (principal amount)	(809,546)
Investment premium amortization*	(28,385)
<b>Residential mortgage investments, end of quarter</b>	<b>\$ 13,854,405</b>

\* *Residential mortgage investments typically are acquired at a premium to the securities' unpaid principal balances. Investment premiums are recognized in earnings as portfolio yield adjustments using the interest method over the estimated lives of the related investments. As such, the level of mortgage prepayments impacts how quickly investment premiums are amortized.*

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 the Company's 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 the average length of time until the loans underlying each security reset to more current rates (months-to-roll) (less than 18 months for current-reset ARM securities, and 18 months or greater for longer-to-reset ARM securities). After consideration of any applicable initial fixed-rate periods, at March 31, 2013 approximately 81%, 11% and 8% of the Company's ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly. Approximately 94% of the Company's current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an initial coupon reset date. Additionally, at March 31, 2013 approximately 17% of the Company's ARM securities were backed by interest-only loans that have not reached an initial coupon reset date. All percentages are approximate and based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated date.

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Capstead's ARM holdings featured the following characteristics at March 31, 2013 (dollars in thousands):

<i>ARM Type</i>	<i>Amortized Cost Basis</i> <sup>(a)</sup>	<i>Net WAC</i> <sup>(b)</sup>	<i>Fully Indexed WAC</i> <sup>(b)</sup>	<i>Average Net Margins</i> <sup>(b)</sup>	<i>Average Periodic Caps</i> <sup>(b)</sup>	<i>Average Lifetime Caps</i> <sup>(b)</sup>	<i>Months To Roll</i>
<b>Current-reset ARMs:</b>							
Fannie Mae Agency Securities	\$ 5,058,011	2.42%	2.23%	1.70%	3.19%	10.15%	5.0
Freddie Mac Agency Securities	1,774,766	2.62	2.35	1.84	2.02	10.67	5.6
Ginnie Mae Agency Securities	815,042	2.44	1.68	1.51	1.02	9.17	7.2
Residential mortgage loans	4,759	3.49	2.33	2.04	1.51	10.97	4.5
	7,652,578	2.47	2.20	1.71	2.69	10.16	5.4
<b>Longer-to-reset ARMs:</b>							
Fannie Mae Agency Securities	3,132,756	2.94	2.49	1.76	4.92	7.95	43.6
Freddie Mac Agency Securities	1,924,697	2.96	2.56	1.84	4.94	7.98	46.1
Ginnie Mae Agency Securities	817,222	2.96	1.67	1.51	1.03	7.99	29.6
	5,874,675	2.95	2.40	1.75	4.39	7.96	42.5
	\$ 13,527,253	2.68	2.29	1.73	3.43	9.21	21.3
Gross WAC (rate paid by borrowers) <sup>(c)</sup>		3.29					

(a) *Amortized cost basis represents Capstead's investment (unpaid principal balance plus \$413 million of unamortized investment premiums, and excluding \$319 million of unrealized gains). At March 31, 2013, the ratio of amortized cost basis to unpaid principal balance for the Company's ARM securities was 103.15. This table excludes \$8 million in fixed-rate residential mortgage investments.*

(b) *Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments, net of servicing and other fees as of the indicated date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the underlying mortgage loans. 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 represent the weighted average levels 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 are subject only to lifetime caps or are not subject to a cap. For presentation purposes, average periodic caps 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, 79% of current-reset ARMs were subject to periodic caps averaging 1.85%; 6% were subject to initial caps averaging 2.22%; 14% were subject to lifetime caps, less the current net WAC, averaging 7.59%; and 1% were not subject to a cap. All longer-to-reset ARM securities at March 31, 2013 were subject to initial caps.*

(c) *Gross WAC is the weighted average interest rate of the mortgage loans underlying the Company's ARM holdings, including servicing and other fees paid by borrowers, as of the indicated date.*

Capstead generally pledges its residential mortgage investments as collateral under repurchase arrangements with commercial banks and other financial institutions, referred to as counterparties, the terms and conditions of which are negotiated on a transaction-by-transaction basis when each borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings by the Company. 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. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a haircut. Haircut requirements for pledged Agency Securities have remained relatively stable since early in 2009 and as of March 31, 2013, haircuts on outstanding borrowings averaged 4.4 percent and ranged from 3.0 to 5.0 percent of the fair value of the pledged securities. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had \$657 million of capital at risk with its lending

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counterparties as of March 31, 2013.

Interest rates charged on repurchase arrangements 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. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly

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security pay down 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 collateral fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls. The Company's borrowings under repurchase arrangements and similar borrowings at March 31, 2013 consisted of \$12.82 billion of primarily 30-day borrowings with 24 counterparties at average rates of 0.40%, before the effects of interest rate swap agreements held as cash flow hedges (see below) and 0.55% including the effects of these derivatives.

To help mitigate exposure to higher short-term interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. Variable payments received by the Company under these 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. These adjustments include 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 March 31, 2013, the Company is required to pay fixed rates of interest averaging 0.67% on notional amounts totaling \$4.20 billion with average remaining interest payment terms of 12 months. As of quarter-end the Company had also entered into forward-starting swap agreements with notional amounts totaling \$2.10 billion that will begin requiring interest payments at fixed rates averaging 0.45% for two-year periods that commence on various dates between June 2013 and January 2014, with an average expiration of 31 months. After consideration of all swap positions entered into as of quarter-end to hedge short-term borrowing rates, the Company's residential mortgage investments and related borrowings under repurchase arrangements had estimated durations at March 31, 2013 of ten months and nine months, respectively, for a net duration gap of approximately one month—see pages 31 and 32 under the caption "Interest Rate Risk" for further information. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repurchase arrangements if available at attractive terms.

Components of quarterly financing spreads on residential mortgage investments, a non-GAAP financial measure, and mortgage prepayment rates, expressed as an annualized constant prepayment rate, or "CPR," were as follows for the past five quarters:

	2013		2012		
	Q1	Q4	Q3	Q2	Q1
Yields on residential mortgage investments: <sup>(a)</sup>					
Cash yields	2.57%	2.60%	2.65%	2.71%	2.74%
Investment premium amortization	(0.84)	(0.84)	(0.79)	(0.67)	(0.60)
Adjusted yields	1.73	1.76	1.86	2.04	2.14
Related borrowing rates: <sup>(b)</sup>					
Unhedged borrowing rates	0.41	0.45	0.41	0.37	0.32
Fixed swap rates	0.71	0.75	0.78	0.80	0.85
Adjusted borrowing rates	0.58	0.63	0.56	0.54	0.49
Financing spreads on residential mortgage investments	1.15	1.13	1.30	1.50	1.65
CPR	19.65	19.60	18.74	15.86	14.50

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

(b) Unhedged borrowing rates represent average rates on repurchase agreements and similar borrowings. Fixed swap rates represent the average fixed rates on currently-paying interest rate swap agreements used to hedge short-term borrowing rates. Adjusted borrowing rates reflect unhedged borrowing rates and fixed swap rates after adjustments for differences between variable rate payments received on currently-paying swap agreements, which typically are based on one-month LIBOR, as well as any measured hedge ineffectiveness, calculated on an annualized basis on average outstanding balances for the indicated periods.

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

	2013		2012		
	Q1	Q4	Q3	Q2	Q1
Financing spreads on residential mortgage investments	1.15%	1.13%	1.30%	1.50%	1.65%
Impact of yields on other interest-earning assets*	(0.05)	(0.07)	(0.05)	(0.06)	(0.06)
Impact of borrowing rates on unsecured borrowings and other interest-paying liabilities*	(0.06)	(0.06)	(0.06)	(0.07)	(0.07)
Total financing spreads	1.04	1.00	1.19	1.37	1.52

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

First quarter 2013 cash yields declined by three basis points from fourth quarter 2012 cash yields reflecting lower coupon interest rates on mortgage loans underlying the Company's holdings of ARM securities as a result of changes in portfolio composition due to acquisitions and portfolio runoff as well as ARM loan coupon resets. Declines in coupon interest rates because of ARM coupon resets have moderated as an increasing number of these loans approach fully-indexed levels. For the same periods, stable quarter over quarter mortgage prepayment levels resulted in no change to the yield adjustment necessary for investment premium amortization. Investment premium amortization is primarily driven by changes in mortgage prepayment rates, but is also influenced by investment premium levels. Because of higher prices paid in recent years for acquisitions as well as runoff of older, lower-basis securities, the Company's cost basis in its portfolio (expressed as a ratio of amortized cost basis to unpaid principal balance) increased 6 basis points during the first quarter of 2013 to 103.15 and has increased 39 basis points since the beginning of 2012. A higher cost basis in the portfolio contributes to larger yield adjustments for investment premium amortization over time.

Unhedged borrowing rates decreased during the first quarter of 2013 due to lower market rates. Fixed swap rates decreased since December 31, 2012 due to the replacement of \$1.10 billion notional amount of interest rate swaps with average fixed rates of 0.81% with \$1.10 billion notional amount of previously acquired interest rate swap agreements with average fixed rates of 0.50% for two-year terms. Over the remainder of 2013 another \$1.80 billion notional amount of swap agreements with average fixed rates of 0.87% will mature and have been replaced with swap agreements that have average fixed rates of 0.45%. See NOTE 7 to the consolidated financial statements for further information regarding the Company's currently-paying and forward-starting swap agreements.

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

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

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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). The Company's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of March 31, 2013 in comparison with December 31, 2012 (in thousands):

	<i>Investments</i> <i>(a)</i>	<i>Related</i> <i>Borrowings</i>	<i>Capital</i> <i>Employed</i>	<i>Potential</i> <i>Liquidity</i> <i>(b)</i>	<i>Portfolio</i> <i>Leverage</i> <i>(c)</i>
<b>Balances as of March 31, 2013:</b>					
Residential mortgage investment portfolio	\$ 13,854,405	\$ 12,821,519	\$ 1,032,886	\$ 427,997	
Cash collateral receivable from swap counterparties, net <i>(d)</i>			15,584		
Other assets, net of other liabilities			541,600	471,510	
			\$ 1,590,070	\$ 899,507	8.06:1
<b>Balances as of December 31, 2012</b>					
	\$ 13,860,158	\$ 12,784,238	\$ 1,597,103	\$ 890,625	8.00:1

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

*(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) Portfolio leverage is expressed as the ratio of repurchase agreements and similar borrowings (Related Borrowings in the table above) to long-term investment capital (total Capital Employed in the table above).*

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

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap program-related margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (remitted to the Company 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and therefore increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to address challenging market conditions and limits exposure to any individual counterparty. The Company has maintained portfolio leverage at approximately eight to one since early 2011 which management believes represents an appropriate and prudent use of leverage for a portfolio of Agency Securities under current market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities.

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	<i>Quarter Ended March 31</i>	
	<i>2013</i>	<i>2012</i>
<b>Income statement data: (in thousands, except per share data)</b>		
Interest income:		
Residential mortgage investments	\$ 58,468	\$ 65,733
Other	112	150
	58,580	65,883
Interest expense:		
Repurchase arrangements and similar borrowings	(18,468)	(14,103)
Unsecured borrowings	(2,187)	(2,187)
	(20,655)	(16,290)
	37,925	49,593
Other revenue (expense):		
Miscellaneous other revenue (expense)	(30)	(169)
Incentive compensation	(351)	(1,538)
Salaries and benefits	(1,610)	(1,827)
Other general and administrative expense	(1,081)	(954)
	(3,072)	(4,488)
Equity in earnings of unconsolidated affiliates	65	65
Net income	\$ 34,918	\$ 45,170
Diluted earnings per diluted common share	\$ 0.31	\$ 0.44
Average diluted shares outstanding	95,450	89,859
<b>Key operating statistics: (dollars in millions)</b>		
Average yields:		
Residential mortgage investments	1.73%	2.14%
Other interest-earning assets	0.11	0.15
Total weighted average yields	1.68	2.08
Average borrowing rates:		
Repurchase arrangements and similar borrowings:		
Unhedged borrowing rates	0.41	0.32
As adjusted for interest rate hedging transactions	0.58	0.49
Unsecured borrowings	8.49	8.49
Total average borrowing rates	0.64	0.56
Total average financing spreads	1.04	1.52
Average financing spreads on residential mortgage investments	1.15	1.65
Average net yield on total interest-earning assets	1.09	1.57
Average CPR	19.65	14.50
Average balance information:		
Residential mortgage investments (cost basis)	\$ 13,543	\$ 12,280
Other interest-earning assets	428	387
Repurchase arrangements and similar borrowings	12,769	11,555
Currently-paying swap agreements (notional amounts)	4,293	3,567
Unsecured borrowings (included in long-term investment capital)	103	103

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Long-term investment capital	1,605	1,454
Portfolio leverage	7.96:1	7.95:1
Incentive compensation, salaries and benefits and other general and administrative expense as a percentage of average long-term investment capital	0.77%	1.19%
Return on average long-term investment capital	9.36	13.08
Return on average common equity capital	9.14	13.76

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Capstead's net income totaled \$35 million or \$0.31 per diluted common share for the quarter ended March 31, 2013, compared to \$45 million or \$0.44 per diluted common share for the same period in 2012. The decrease in net income can largely be attributed to a decrease in portfolio yields and an increase in borrowing rates since March 31, 2012. Financing spreads on residential mortgage investments averaged 1.15% during the quarter ended March 31, 2013, compared to 1.65% reported for the same period in 2012. Lower financing spreads during the first quarter of 2013 compared to the same period in 2012 reflect (a) lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates underlying the portfolio resetting lower to more current rates as well as lower coupon interest rates on acquisitions, and (b) higher investment premium amortization primarily because of higher levels of mortgage prepayments as well as higher prices paid for portfolio acquisitions in recent years. Unhedged borrowing rates for the first quarter 2013 were higher than rates in effect during the first quarter of 2012 because of changes in market conditions. A portion of this increase was offset by lower rates on currently-paying interest rate swap agreements. Incentive compensation, salaries and benefits and other general and administrative expense (referred to as operating costs), as a percentage of average long-term investment capital, declined 42 basis points to 0.77% during the first quarter of 2013 compared to the first quarter of 2012 primarily reflecting lower performance-based compensation costs.

Yields on residential mortgage securities averaged 1.73% during the quarter ended March 31, 2013, compared to 2.14% for the same period in 2012. Cash yields averaged 2.57% during the quarter ended March 31, 2013, which were 17 basis points lower than cash yields reported for the same period in 2012. Investment premium amortization totaled \$28 million for the quarter ended March 31, 2013, representing a yield adjustment of 84 basis points, compared to amortization of \$18 million or 60 basis points for the same period in 2012. Approximately 90% of the increase in investment premium amortization is attributable to higher levels of mortgage prepayments due largely to lower prevailing mortgage interest rates with the remaining increase attributable to increases in the cost basis of the portfolio.

Borrowing rates on repurchase arrangements and similar borrowings, adjusted for interest rate hedging transactions, averaged 0.58% during the quarter ended March 31, 2013, an increase of 9 basis points from rates reported for the same period in 2012. Before adjustment for the effects of interest rate swap agreements held as cash flow hedges, rates on these borrowings averaged 0.41% during the first quarter of 2013, which was 9 basis points higher than rates reported for the same period in 2012 due to changes in market conditions, including competition for borrowings with the recent growth of the mortgage REIT industry. Rates on approximately \$4.29 billion of the Company's average borrowings during the quarter ended March 31, 2013 were effectively fixed through the use of interest rate swap agreements. The corresponding amount was \$3.57 billion for the same period in 2012. Fixed-rate payment requirements on the Company's currently-paying swap positions, before certain adjustments including the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and related actual borrowings, averaged 0.71% for the first quarter of 2013, which was 14 basis points lower than rates reported for the same period in 2012 reflecting the expiration of older, higher-rate swaps that were replaced at lower rates.

Operating costs as a percentage of long-term investment capital averaged 0.77% during the first quarter of 2013, which was 42 basis points lower compared to the same period in 2012. This decline is attributable to a 10% increase in average long-term investment capital and a 42% decrease in compensation costs, reflecting lower accruals under performance-based employee compensation programs, particularly the Company's incentive compensation program that provides for a participation in annual earnings in excess of a benchmark amount. See NOTE 10 to the accompanying consolidated financial statements for additional information regarding the Company's compensation programs.

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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 inherent in its unencumbered residential mortgage investments is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under "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 March 31, 2013 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, any additional common share repurchases, repayments on borrowings and the payment of cash dividends as required for the Company's continued qualification as a REIT. It is the Company's policy to remain strongly capitalized and conservatively leveraged.

Capstead generally pledges its residential mortgage investments as collateral under repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. As of March 31, 2013, the Company had uncommitted repurchase facilities with a variety of lending counterparties to finance its portfolio, subject to certain conditions, and had borrowings outstanding with 24 of these counterparties. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Borrowings under repurchase arrangements increased to \$12.82 billion at March 31, 2013, primarily with original maturities of 30 days. Borrowings under repurchase arrangements began the year at \$12.78 billion and averaged \$12.77 billion during the first quarter of 2013. Average borrowings during the quarter can differ from quarter-end balances for a number of reasons including portfolio growth or contraction as well as differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to higher short-term interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. At March 31, 2013 currently-paying swap agreements entered into by the Company had notional amounts totaling \$4.20 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 March 31, 2013 the Company held forward-starting swap agreements for this purpose with notional amounts totaling \$2.10 billion that begin two-year interest payment terms on various dates between June 2013 and January 2014 with an average expiration of 31 months. Relative to the floating rate terms of the Company's \$100 million in unsecured borrowings that begin at various dates between October 2015 and September 2016, the Company entered into forward-starting swap agreements to effectively lock in fixed rates of interest averaging 7.56% for the final 20 years of these borrowings that mature in 2035 and 2036. The Company intends to continue to utilize suitable derivative financial instruments such as interest rate swap agreements to manage interest rate risk.

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In late 2012 the Company implemented a \$100 million common share repurchase program and suspended its continuous offering program until further notice. Purchases made pursuant to the common share repurchase program can be made in the open market or through privately negotiated transactions from time to time as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any repurchases are determined by the Company in its discretion and are subject to economic and market conditions, share price, applicable legal requirements and other factors. Pursuant to this authorization, in November and December 2012 repurchases totaled 3.0 million common shares at an average cost of \$11.80 per share for \$35 million. An additional 638,000 shares were repurchased in early January 2013 at an average cost of \$11.43 per share for \$7 million. No further repurchases have been made since January, leaving \$58 million of the authorization available for future repurchases. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. Upon suspension of the repurchase program, issuances of common shares under the continuous offering program or by other means may resume subject to compliance with federal securities laws, market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

### ***Interest Rate Risk***

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

To further mitigate Capstead's exposure to higher short-term interest rates, the Company uses currently-paying and forward-starting interest rate swap agreements that typically require interest payments for two-year terms in order to lengthen the effective duration of its borrowings to more closely match the duration of its investments. Duration is a measure of market price sensitivity to interest rate movements. After consideration of all swap positions entered into as of quarter-end to hedge short-term borrowing rates, the Company's residential mortgage investments and related borrowings under repurchase arrangements had estimated durations at March 31, 2013 of ten months and nine months, respectively, for a net duration gap of approximately one month. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repurchase arrangements if available at attractive terms.

Capstead performs sensitivity analyses using a model to estimate the effects that specific interest rate changes can reasonably be expected to have on net interest margins and portfolio values. All investments, related borrowings and derivative financial instruments held are included in these analyses. For net interest margin modeling purposes, the model incorporates management's assumptions for mortgage prepayment levels for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums and reinvesting portfolio runoff. 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. For portfolio valuation modeling purposes, a static portfolio is assumed. This modeling is the primary tool used by management to assess the direction and magnitude of changes in net interest margins and portfolio values resulting solely from changes in interest rates. Key modeling assumptions include mortgage prepayment speeds, adequate levels of market liquidity, current market conditions, and portfolio leverage levels. Given the present low

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level of interest rates, a floor of 0.00% is assumed. However, it is assumed that borrowing rates cannot decline beyond a certain level. These assumptions are inherently uncertain and, as a result, modeling cannot precisely estimate the impact of higher or lower interest rates. Actual results will differ from simulated results due to the timing, magnitude and frequency of interest rate changes, other changes in market conditions, changes in management strategies and other factors.

The table below reflects the estimated impact of instantaneous parallel shifts in the yield curve on net interest margins and the fair value of Capstead's portfolio of residential mortgage investments and related derivatives at March 31, 2013 and December 31, 2012, subject to the modeling parameters described above.

	<i>Federal Funds Rate</i>	<i>10-year U.S. Treasury Rate</i>	<i>Down 0.50%</i>	<i>Up 0.50%</i>	<i>Up 1.00%</i>
Projected 12-month percentage change in net interest margins: *					
March 31, 2013	<0.25%	1.85%	(2.5)%	(5.8)%	(13.0)%
December 31, 2012	<0.25	1.76	(1.7)	(6.2)	(13.7)
Projected percentage change in portfolio and related derivative values: *					
March 31, 2013	<0.25%	1.85%	%	(0.1)%	(0.2)%
December 31, 2012	<0.25	1.76		(0.2)	(0.3)

\* *Sensitivity of net interest margins as well as portfolio and related derivative values to changes in interest rates is determined relative to the actual rates at the applicable date. Note that the projected 12-month net interest margin 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, if investments made will behave in the same fashion as assets currently held or if management will choose to replace runoff with such assets.*

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**RISK FACTORS**

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

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

*Monetary policy actions by the Federal Reserve could adversely affect Capstead's liquidity, financial condition and earnings. In order to help support the GSEs and the housing markets, by early 2010 the Federal Reserve had acquired \$1.25 trillion in Agency Securities. This expansion of the Federal Reserve's balance sheet is often referred to as quantitative easing or QE. In September 2011, in order to promote a stronger economic recovery the Federal Reserve began extending the average maturity of its holdings of securities by selling Treasury securities with maturities of less than three years and purchasing longer-dated Treasuries. This program was referred to as Operation Twist. Also in September 2011, the Federal Reserve began reinvesting principal payments from existing holdings of Agency Securities into additional Agency Securities. In September 2012, the Federal Reserve began purchasing additional Agency Securities at a pace of \$40 billion per month and announced it would maintain its existing policy of reinvesting principal payments from its existing holdings of Agency Securities. The Federal Reserve articulated that these additional purchases of Agency Securities, referred to as QE3, will continue until the labor market improves substantially.*

These policy initiatives have put upward pressure on pricing for Agency Securities resulting in downward pressure on yields on new purchases of Agency Securities and downward pressure on mortgage interest rates, which generally results in higher mortgage prepayment rates. The Company's net interest margins, and therefore earnings, are being adversely affected over time as the Company's existing portfolio runs off and is replaced with higher cost, lower yielding securities. See discussion below regarding the negative effects of higher mortgage prepayment levels. In addition, should the Federal Reserve decide to reduce its holdings of Agency Securities through asset sales, the pricing of these investments could decline, which could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described below.

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

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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 have in the housing markets. The actual or perceived credit quality of Agency Securities could be adversely affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Ginnie Mae, the GSEs or their successors could adversely affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of Agency Securities remains viable, which could adversely affect earnings and book value per common share.

*Failure of the federal government to reduce future federal budget deficits could adversely impact Capstead's liquidity, financial condition and earnings.* Federal budget deficit concerns have increased the possibility of a decrease in the market's perception of the creditworthiness of debt securities issued by or guaranteed by the federal government and of further credit rating agency actions to downgrade the federal government's credit rating. Because market participants rely on the federal government's continued support of the GSEs, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings of Agency Securities could be adversely affected. In addition, these circumstances could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of borrowings under repurchase arrangements which could adversely impact the Company's liquidity, earnings and book value per common share, as more fully described below.

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

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

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prepays. Additionally, heightened prepayment exposure due to the real or perceived potential for government intervention could adversely affect pricing for Agency Securities in general and, as a result, liquidity and book value per common share could be adversely affected due to declines in the fair value of the Company's remaining portfolio.

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

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

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

*Periods of illiquidity in the mortgage markets may reduce amounts available to be borrowed under Capstead's repurchase arrangements due to declines in the perceived value of related collateral, which could adversely impact the Company's liquidity, financial condition and earnings.* Capstead generally finances its residential mortgage investments by pledging them as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis. The amount borrowed under a repurchase arrangement is limited to a percentage of the estimated market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by the lender that is not advanced under the repurchase arrangement is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the perceived market value of the pledged collateral as

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determined by the Company's lenders declines, the Company may be subject to margin calls wherein the lender requires the Company to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, Capstead may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

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

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

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



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

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

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

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

*The lack of availability of suitable investments at attractive pricing may adversely affect Capstead's earnings.* The pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than Capstead. Additionally, in recent years the federal government, primarily through the Federal Reserve, has been an active buyer of Agency Securities which has had the effect of supporting, if not increasing, pricing for these securities. To the extent the proceeds from prepayments on Capstead's mortgage investments are not reinvested or cannot be reinvested at rates of return at least equal to the rates previously earned on those investments, the Company's earnings may be adversely affected. Similarly, if proceeds from capital

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raising activities are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can the Company assure investors that it will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

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

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

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

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

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

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

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

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

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

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

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

*Complying with REIT requirements may limit Capstead's ability to hedge effectively.* The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from unqualified hedges together with any other income



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

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

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

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

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

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

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

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

*Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations.* The Investment Company Act of 1940 (the "40 Act") exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the 40 Act. For over 30 years, the staff of the SEC has interpreted the provisions of the 40 Act to require, among other things, a REIT to maintain at least 55% of its assets directly in qualifying real estate interests and at least 80% of its assets in real estate-related assets in order to be exempt from regulation as an investment company. Critical to Capstead's exemption from regulation as an investment company is the long-standing SEC staff interpretation that so called whole loan mortgage securities, in which an investor holds all issued certificates with respect to an underlying pool of mortgage loans, constitutes a qualifying real estate interest for purposes of the staff's 55% qualifying real estate interest requirement. Conversely, so called partial pool mortgage securities presently do not qualify for purposes of meeting the 55% requirement, although they are considered by the staff to be real estate-related assets for purposes of meeting the staff's 80% real estate-related asset requirement.

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

*Pursuant to Capstead's charter, its board of directors has the ability to limit ownership of the Company's capital stock, to the extent necessary to preserve its REIT qualification.* For the purpose of preserving Capstead's REIT qualification, the Company's charter gives the board the ability to repurchase outstanding shares of capital stock from existing stockholders if the directors determine in good faith that

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the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of the Company's outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

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

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

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

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

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

*There are risks associated with ownership of Capstead's Series 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 economically advantageous to do so given existing conversion ratios and current trading levels of the Company's common shares.

*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, existing preferred shares.

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*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, 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 existing preferred shares, (ii) the creation of additional classes or series of preferred stock that are senior to existing preferred shares, (iii) any failure to pay dividends on 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, or the Company's participation in any merger or consolidation.

*Capstead may change its policies without stockholder approval.* Capstead's board and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company's stockholders. Policy changes could adversely affect the Company's financial condition, results of operations, the market price of its common and preferred stock or the Company's ability to pay dividends or 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 residential mortgage investments* Investment premiums on residential mortgage investments are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. For most of Capstead's residential mortgage investments, estimates and judgments related to future levels of mortgage prepayments are critical to this determination. Mortgage prepayment expectations can change based on how current and projected changes in interest rates impact the economic attractiveness of mortgage refinance opportunities, if available, and other factors such as portfolio composition. In recent years, the ability of mortgagors to refinance has also been impacted by more stringent loan underwriting practices and lending industry capacity restraints, government-sponsored mortgagor relief programs, low housing prices and credit problems being experienced by many of these borrowers. Management estimates mortgage prepayments based on past experiences with specific investments within the portfolio in addition to the factors mentioned above. Should actual prepayment rates differ materially from these estimates, investment premiums would be expensed at a different pace.

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*Fair value and impairment accounting for residential mortgage investments* All but \$13 million of Capstead's residential mortgage investments are held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in *Stockholders' equity* as a component of *Accumulated other comprehensive income*. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions. Considerable judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 9 to the consolidated financial statements (included under Item 1 of this report) for discussion of how Capstead values its residential mortgage investments. Generally, gains or losses are recognized in earnings only if sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of *Other revenue (expense)* if the decline was credit-related or it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary impairment of a mortgage security due to other factors would be recognized in *Accumulated other comprehensive income* and amortized to earnings as a yield adjustment.

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

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

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



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**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, will be, will likely continue, will likely result, 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 exemptions for mortgage REITs from regulation under the Investment Company Act of 1940;

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

deterioration in credit quality and ratings of existing or future issuances of Agency Securities; 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.



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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS**

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

**ITEM 4. CONTROLS AND PROCEDURES**

As of March 31, 2013, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2013. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to March 31, 2013.

**PART II. OTHER INFORMATION**

**ITEM 6. EXHIBITS**

**Exhibit**

<b>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>(2)</sup>
3.3	Articles of Amendment of Articles of Incorporation dated as of May 29, 2008. <sup>(3)</sup>
4.1	Junior Subordinated Indenture dated September 26, 2005, pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(2)</sup>
4.2	Amended and Restated Trust Agreement dated September 26, 2005, pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(2)</sup>
4.3	Indenture dated December 15, 2005, regarding junior subordinated debentures due 2035, including a form of debenture pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(2)</sup>
4.4	Amended and Restated Declaration of Trust dated December 15, 2005, including forms of capital security certificates pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(2)</sup>
4.5	Indenture dated September 11, 2006, regarding junior subordinated debentures due 2036, including a form of debenture pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(2)</sup>
4.6	Amended and Restated Declaration of Trust dated September 11, 2006, including forms of capital security certificates pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(2)</sup>
10.01	Amended and Restated Deferred Compensation Plan. <sup>(2)</sup>
10.02	Amended and Restated 2004 Flexible Long-Term Incentive Plan. <sup>(4)</sup>
10.03	Second Amended and Restated Incentive Bonus Plan. <sup>(5)</sup>
10.04	Form of nonqualified stock option and stock award agreements for non-employee directors. <sup>(2)</sup>
10.05	Form of nonqualified stock option and stock award agreements for employees with service conditions. <sup>(2)</sup>
10.06	Form of stock award agreements for employees with performance conditions. <sup>(6)</sup>
10.07	Form of stock award agreements for employees with performance conditions and deferral of dividends. <sup>(7)</sup>

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10.08	Purchase Agreements dated September 23, 2005, pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(2)</sup>
10.09	Placement Agreement dated December 6, 2005, pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(2)</sup>
10.10	Placement Agreement dated September 8, 2006, pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(2)</sup>
12	Computation of ratio of net income to fixed charges and ratio of net income to combined fixed charges and preferred stock dividends.*
31.1	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
31.2	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**
101.INS	XBRL Instance Document***
101.SCH	XBRL Taxonomy Extension Schema***
101.CAL	XBRL Taxonomy Extension Calculation Linkbase***
101.DEF	XBRL Additional Taxonomy Extension Definition Linkbase***
101.LAB	XBRL Taxonomy Extension Label Linkbase***
101.PRE	XBRL Taxonomy Extension Presentation Linkbase***

- (1) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-63358) dated June 19, 2001.
  - (2) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011.
  - (3) Incorporated by reference to the Registrant's Current Report on Form 8-K dated May 30, 2008.
  - (4) Incorporated by reference to the Registrant's Registration Statement on Form S-8 (No. 333-142861) dated May 9, 2007.
  - (5) Incorporated by reference to the Registrant's Current Report on Form 8-K dated May 4, 2011.
  - (6) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008.
  - (7) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2010.
- \* Filed herewith  
 \*\* Furnished herewith  
 \*\*\* Submitted electronically 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: May 2, 2013

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

Date: May 2, 2013

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

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