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CHIMERA INVESTMENT CORP
Form 10-Q
November 10, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED: SEPTEMBER 30, 2008

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: 1-13447

CHIMERA INVESTMENT CORPORATION
(Exact name of Registrant as specified in its Charter)

MARYLAND 26-0630461
(State or other jurisdiction of incorporation (IRS Employer Identification No.)
or organization)

1211 AVENUE OF THE AMERICAS, SUITE 2902
NEW YORK, NEW YORK
(Address of principal executive offices)

10036
(Zip Code)

(646) 454-3759
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all documents and 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 is a large accelerated filer, an accelerated filer, non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer," "large 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

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APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class	Outstanding at November 10, 2008
Common Stock, \$.01 par value	177,170,098

CHIMERA INVESTMENT CORPORATION

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PART I.

ITEM 1. FINANCIAL STATEMENTS

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CHIMERA INVESTMENT CORPORATION
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(dollars in thousands, except per share data)

	September 30, 2008 (unaudited)	December 31, 2007 (1)
	-----	-----
ASSETS		

Cash and cash equivalents	\$ 6,167	\$ 6,026
Restricted cash	-	1,350
Reverse repurchase agreements	-	265,000
Mortgage-Backed Securities, at fair value	759,378	1,124,290
Loans held for investment, net of allowance for loan losses of \$0 and \$81, respectively	-	162,371
Securitized loans held for investment, net of allowance for loan losses of \$681 and \$0, respectively	598,014	-
Accrued interest receivable	8,212	6,036
Other assets	456	563
	-----	-----
Total assets	\$ 1,372,227	\$ 1,565,636
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		

Liabilities:		
Repurchase agreements	\$ 619,657	\$ 270,584
Securitized debt	500,688	-
Payable for investments purchased	-	748,920
Accrued interest payable	2,579	415
Dividends payable	6,048	943
Accounts payable and other liabilities	2,313	1,729
Interest rate swaps, at fair value	-	4,156
	-----	-----
Total liabilities	1,131,285	1,026,747
	-----	-----
Commitments and Contingencies (Note 14)		
Stockholders' Equity:		
Common stock: par value \$.01 per share; 500,000,000 shares authorized, 38,992,893 and 37,705,563 shares issued and outstanding, respectively	378	377
Additional paid-in capital	533,220	532,208
Accumulated other comprehensive (loss) income	(138,307)	10,153
Accumulated deficit	(154,349)	(3,849)
	-----	-----
Total stockholders' equity	240,942	538,889
	-----	-----
Total liabilities and stockholders' equity	\$ 1,372,227	\$ 1,565,636
	=====	=====

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(1) Derived from the audited statement of financial condition at December 31, 2007.
See notes to consolidated financial statements.

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CHIMERA INVESTMENT CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(dollars in thousands, except per share data)
(unaudited)

	For the Quarter Ended September 30, 2008	For the Nine Months Ended September 30, 2008
	-----	-----
Interest income	\$ 23,458	\$ 81,603
Interest expense	15,543	49,590
	-----	-----
Net interest income	7,915	32,013
	-----	-----
Unrealized gains on interest rate swaps	10,065	4,156
Realized losses on sales of investments	(113,130)	(144,304)
Realized losses on terminations of interest rate swaps	(10,460)	(10,337)
	-----	-----
Net investment expense	(105,610)	(118,472)
	-----	-----
Other expenses		
Management fee	1,681	6,136
General and administrative expenses	253	3,972
	-----	-----
Total expenses	1,934	10,108
	-----	-----
Loss before income taxes	(107,544)	(128,580)
	-----	-----
Income tax	12	15
	-----	-----
Net loss	\$ (107,556)	\$ (128,595)
	=====	=====
Net loss per share - basic and diluted	\$ (2.76)	\$ (3.30)
	=====	=====
Weighted average number of shares outstanding - basic and diluted	38,992,893	38,994,357
	=====	=====
Comprehensive Loss:		
Net loss	\$ (107,556)	\$ (128,595)
	-----	-----
Other comprehensive loss:		
Unrealized loss on available-for-sale securities	(146,456)	(282,611)

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Reclassification adjustment for realized losses included in net income	113,130	144,304
	-----	-----
Other comprehensive loss	(33,326)	(138,307)
	-----	-----
Comprehensive loss	\$ (140,882)	\$ (266,902)
	=====	=====

See notes to consolidated financial statements.

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CHIMERA INVESTMENT CORPORATION
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(dollars in thousands, except per share data)
(unaudited)

	Common Stock Par Value	Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Accu De
Balance, January 1, 2008	\$ 377	\$ 532,208	\$ 10,153	\$
Net loss	-	-	-	
Other comprehensive loss	-	-	(148,460)	
Costs associated with common stock offering	-	(277)	-	
Restricted stock grants	1	1289	-	
Common dividends declared, \$0.16 per share	-	-	-	
	-----	-----	-----	-----
Balance, September 30, 2008	\$ 378	\$ 533,220	\$ (138,307)	\$
	=====	=====	=====	=====

See notes to consolidated financial statements.

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CHIMERA INVESTMENT CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)
(unaudited)

	For the Quarter Ended September 30, 2008	For the Nine Months Ended September 30, 2008
Cash Flows From Operating Activities:		
Net loss	\$ (107,556)	\$ (128,595)
	-----	-----

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Adjustments to reconcile net loss to net cash provided by		
(used in) operating activities:		
Amortization of investment premiums and discounts	908	(25)
Unrealized gains on interest rate swaps	(10,065)	(4,156)
Realized losses on sale of investments	113,130	144,304
(Benefit) provision for loan losses	(563)	600
Restricted stock grants expense	254	1,289
Changes in operating assets		
Decrease (increase) in accrued interest receivable	1,651	(3,874)
Decrease in other assets	1,192	106
Changes in operating liabilities		
(Decrease) increase in accounts payable	(570)	434
(Decrease) increase in accrued interest payable	(939)	2,165
(Decrease) increase in other liabilities	(657)	150
	-----	-----
Net cash provided by (used in) operating activities	(3,215)	12,398
	-----	-----
Cash Flows From Investing Activities:		
Mortgage-Backed securities portfolio:		
Purchases	(708)	(1,229,280)
Sales	319,441	567,455
Principal payments	41,407	144,519
Loans held for investment portfolio:		
Purchases	(146,862)	(735,271)
Sales	-	90,733
Principal payments	1,172	23,115
Securitized loans		
Principal payments	14,892	27,549
Purchases	(111)	(111)
Reverse repurchase agreements	-	265,000
Decrease in restricted cash	29,507	1,350
	-----	-----
Net cash provided by (used in) investing activities	258,738	(844,941)
	-----	-----
Cash Flows From Financing Activities:		
Net proceeds from repurchase agreements	30,563,956	49,177,282
Net payments on repurchase agreements	(30,853,387)	(48,828,209)
Costs associated with common stock offerings	(61)	(277)
Net proceeds from securitized debt	10,314	526,217
Net payments on securitized debt	(14,023)	(25,529)
Dividends paid	(6,044)	(16,800)
	-----	-----
Net cash provided by financing activities	(299,245)	832,685
	-----	-----
Net (decrease) increase in cash and cash equivalents	(43,722)	141
Cash and cash equivalents at beginning of period	49,889	6,026
	-----	-----
Cash and cash equivalents at end of period	\$ 6,167	\$ 6,167
	=====	=====
Supplemental disclosure of cash flow information		
Interest paid	\$ 16,482	\$ 47,425
	=====	=====
Taxes paid	\$ 12	\$ 33
	=====	=====
Non cash investing activities		
Payable for investments purchased	\$ (146,824)	\$ 146,824
	=====	=====
Transfer from loans held for investment		

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to Mortgage-backed securities	\$ 146,862	\$ 146,862
	=====	=====
Net change in unrealized loss on available for sale securities	\$ (33,326)	\$ (138,307)
	=====	=====
Non cash financing activities		
Dividends declared, not yet paid	\$ 6,048	\$ 6,048
	=====	=====

See notes to consolidated financial statements.

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CHIMERA INVESTMENT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE QUARTER ENDED SEPTEMBER 30, 2008
(dollars in thousands, except per share data)
(unaudited)

1. Organization and Significant Accounting Policies

Chimera Investment Corporation, or the Company, was organized in Maryland on June 1, 2007. The Company commenced operations on November 21, 2007 when it completed its initial public offering. The Company has elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended. As such, the Company is required to distribute substantially all of the income generated from its operations to its stockholders. As long as the Company qualifies as a REIT, the Company will generally not be subject to U.S. federal or state corporate taxes on its income to the extent that the Company distributes at least 90% of its taxable net income to its stockholders. The Company is managed by Fixed Income Discount Advisory Company, or FIDAC, an investment advisor registered with the Securities and Exchange Commission. FIDAC is a wholly-owned subsidiary of Annaly Capital Management, Inc., or Annaly.

A summary of the Company's significant accounting policies follows:

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with the instructions to Form 10-Q and Article 10, Rule 10-01 of Regulation S-X for interim financial statements. Accordingly, they may not include all of the information and footnotes required by accounting principles generally accepted in the United States of America, or GAAP. The consolidated interim financial statements are unaudited; however, in the opinion of the Company's management, all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation of the financial position, results of operations, and cash flows have been included. Comparative information for the quarter and nine months ended September 30, 2007 is not provided because the Company did not commence operations until November 21, 2007. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. The nature of the Company's business is such that the results of any interim period are not necessarily indicative of results for a full year.

Cash and Cash Equivalents

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Cash and cash equivalents include cash on hand and money market funds.

Restricted Cash

Restricted cash includes cash held by counterparties as collateral for repurchase agreements and interest rate swaps.

Reverse Repurchase Agreements

The Company may invest its daily available cash balances in reverse repurchase agreements to provide additional yield on its assets. These investments will typically be recorded as short term investments, will mature daily, and are referred to as reverse repurchase agreements in the statement of financial condition. Reverse repurchase agreements are recorded at cost and are collateralized by residential mortgage-backed securities, or RMBS.

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Residential Mortgage-Backed Securities

The Company invests in RMBS representing interests in obligations backed by pools of mortgage loans and carries those securities at fair value estimated using a pricing model. Management reviews the fair values generated to determine that prices are reflective of the current market. Management performs a validation of the fair value calculated by the pricing model by comparing its results to independent prices provided by dealers in the securities and/or third party pricing services. If dealers or independent pricing services are unable to provide a price for an asset, or if the price provided by them is deemed unreliable by FIDAC, then the asset will be valued at its fair value as determined in good faith by FIDAC. In the current market, it may be difficult or impossible to obtain third party pricing on the investments the Company purchases. In addition, validating third party pricing for the Company's investments may be more subjective as fewer participants may be willing to provide this service to the Company. Moreover, the current market is more illiquid than in recent history for some of the investments the Company purchases. Illiquid investments typically experience greater price volatility as a ready market does not exist. As volatility increases or liquidity decreases, the Company may have greater difficulty financing its investments which may negatively impact its earnings and the execution of its investment strategy. Please see Note 5 for a discussion of fair value measurement.

Statement of Financial Accounting Standards, or SFAS, No. 115, Accounting for Certain Investments in Debt and Equity Securities, requires the Company to classify its investment securities as either trading investments, available-for-sale investments or held-to-maturity investments. Although the Company generally intends to hold most of its RMBS until maturity, the Company records its RMBS as available-for-sale and as such may sell any of its RMBS as part of its overall management of its portfolio. All assets classified as available-for-sale are reported at estimated fair value, with unrealized gains and losses included in other comprehensive income.

Management evaluates investment securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been lower than carrying value, (2) the financial condition and near-term prospects of the issuer, (3) credit quality and cash flow performance of the security, and (4) the intent and ability of the Company to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value. Unrealized losses on investment securities that are considered other than temporary, as measured by the amount of decline in fair value attributable to

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other-than-temporary factors, are recognized in income and the cost basis of the investment securities is adjusted.

RMBS transactions are recorded on the trade date. Realized gains and losses from sales of RMBS are determined based on the specific identification method and recorded as a gain (loss) on sale of investments in the statement of operations. Accretion of discounts or amortization of premiums on available-for-sale securities and mortgage loans is computed using the effective interest yield method and is included as a component of interest income in the statement of operations.

The current situation in the mortgage sector and the current weakness in the broader mortgage market could adversely affect one or more of the Company's lenders and could cause one or more of the Company's lenders to be unwilling or unable to provide additional financing. This could potentially increase the Company's financing costs and reduce liquidity. If one or more major market participants fails, it could negatively impact the marketability of all fixed income securities, including government mortgage securities. This could negatively impact the value of the securities in the Company's portfolio, thus reducing its net book value. Furthermore, if many of the Company's lenders are unwilling or unable to provide additional financing, the Company could be forced to sell its Investment Securities at an inopportune time when prices are depressed.

Loans Held for Investment and Securitized Loans Held for Investment

The Company's securitized and un-securitized residential mortgage loans are comprised of fixed-rate and variable-rate loans. The Company purchases pools of residential mortgage loans through a select group of originators. Mortgage loans are designated as held for investment, recorded on trade date, and are carried at their principal balance outstanding, plus any premiums or discounts which are amortized or accreted over the estimated life of the loan, less allowances for loan losses. Loans are evaluated for possible credit losses. The Company has created an unallocated provision for loan losses estimated as a percentage of the remaining principal on the loans. Management's estimate is based on historical experience of similarly underwritten loan pools. There were no losses specifically allocated to loans as of September 30, 2008. From time to time, the Company may securitize loans held for investment. These transactions are recorded in accordance with FAS 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities as either a "sale" and classified as Mortgage-Backed Securities or as a "secured borrowing" and classified as Securitized loans held for investment on the Company's consolidated statement of financial condition.

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Allowance for Loan Losses

The Company has established an allowance for loan losses at a level that management believes is adequate based on an evaluation of known and inherent risks related to the Company's loan portfolio. The estimate is based on a variety of factors including, current economic conditions, industry loss experience, credit quality trends, loan portfolio composition, delinquency trends, national and local economic trends, national unemployment data, changes in housing appreciation and whether specific geographic areas where the Company has significant loan concentrations are experiencing adverse economic conditions and events such as natural disasters that may affect the local economy or property values. Upon purchase of the pools of loans, the Company obtained written representations and warranties from the sellers that the Company could be reimbursed for the value of the loan if the loan fails to meet the agreed upon origination standards. While the Company has little history of its own to

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establish loan trends, delinquency trends of the originators and the current market conditions aid in determining the allowance for loan losses. The Company also performed due diligence procedures on a sample of loans that met its criteria during the purchase process.

When it is probable that specific contractually due amounts are uncollectible, the loan is considered impaired. Where impairment is indicated, a valuation write-off is measured based upon the excess of the recorded investment over the net fair value of the collateral, reduced by selling costs. Any deficiency between the carrying amount of an asset and the net sales price of repossessed collateral is charged to the allowance for loan losses.

Securitized Debt

The Company has issued securitized debt to finance a portion of its residential mortgage loan portfolio. The securitized debt is collateralized by residential adjustable or fixed rate mortgage loans that have been placed in a trust and bear interest and principal payments to the debt holders. The Company's securitized debt is accounted for as borrowings and recorded as a liability on the consolidated statement of financial condition.

Interest Income

Interest income on available-for-sale securities and loans held for investment is recognized over the life of the investment using the effective interest method as described by SFAS No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, for securities of high credit quality and Emerging Issues Task Force No. 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets, for all other securities. Income recognition is suspended for loans when, in the opinion of management, a full recovery of income and principal becomes doubtful. Income recognition is resumed when the loan becomes contractually current and performance is demonstrated to be resumed.

Derivative Financial Instruments/Hedging Activity

The Company economically hedges interest rate risk through the use of derivative financial instruments. If the Company hedges using interest rate swaps it accounts for these instruments as free-standing derivatives. Accordingly, they are carried at fair value with realized and unrealized gains and losses recognized in earnings.

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Income Taxes

The Company intends to qualify to be taxed as a REIT, and therefore it generally will not be subject to corporate federal or state income tax to the extent that qualifying distributions are made to stockholders and the REIT requirements, including certain asset, income, distribution and stock ownership tests are met. If the Company failed to qualify as a REIT and did not qualify for certain statutory relief provisions, the Company would be subject to federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the REIT qualification was lost.

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes, which requires the recognition of deferred income taxes for differences between the basis of assets and liabilities for financial statement and income tax purposes. Deferred tax assets and liabilities represent

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the future tax consequence for those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred taxes are also recognized for operating losses that are available to offset future taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 was effective for the Company upon inception and its effect was not material.

Net Loss per Share

The Company calculates basic net loss per share by dividing net loss for the period by the weighted-average shares of its common stock outstanding for that period. Diluted net loss per share takes into account the effect of dilutive instruments, such as stock options, but uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted average number of shares outstanding. The Company had no potentially dilutive securities outstanding during the periods presented.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with the provisions of SFAS No. 123R, Accounting for Stock-Based Compensation, which establishes accounting and disclosure requirements using fair value based methods of accounting for stock-based compensation plans. Compensation expense related to grants of stock and stock options is recognized over the vesting period of such grants based on the estimated fair value on the grant date.

Stock compensation awards granted to the employees of FIDAC are accounted for in accordance with EITF 96-18, Accounting For Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods and Services, which requires the Company to measure the fair value of the equity instrument using the stock prices and other measurement assumptions as of the earlier of either the date at which a performance commitment by the counterparty is reached or the date at which the counterparty's performance is complete.

Use of Estimates

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

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS 157 requires companies to disclose the fair value of its financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined) and establishes that fair value is based on exit price as of the measurement date.

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SFAS 157 was effective for the Company on January 1, 2008, see Note 5 for the related disclosure.

Subsequently, on October 10, 2008, FASB issued FASB Staff Position (FSP) 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active ("FSP 157-3"), in response to the deterioration of the credit markets. This FSP provides guidance clarifying how SFAS 157, should be applied when valuing securities in markets that are not active. The guidance provides an illustrative example that applies the objectives and framework of SFAS 157, utilizing management's internal cash flow and discount rate assumptions when relevant observable data do not exist. It further clarifies how observable market information and market quotes should be considered when measuring fair value in an inactive market. It reaffirms the notion of fair value as an exit price as of the measurement date and that fair value analysis is a transactional process and should not be broadly applied to a group of assets. FSP 157-3 is effective upon issuance including prior periods for which financial statements have not been issued. The Company does not believe the implementation of FSP 157-3 will have a material effect on the fair value of their assets as the Company intends to continue the methodologies used in previous quarters to value assets as defined under the original SFAS 157.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, or SFAS 159. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS 159 became effective for the Company January 1, 2008. The Company did not elect the fair value option for any existing eligible financial instruments.

In June 2008, the FASB proposed amending SFAS 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities and FIN 46(R), Consolidation of Variable Interest Entities. This was due to increased scrutiny of these accounting pronouncements by the SEC, Congress and financial statement users in the wake of recent deterioration in the credit markets. The proposed amendments would eliminate the Qualified Special Purpose Entity (QSPE) in SFAS 140, and modify the consolidation model in FIN 46(R). QSPEs are utilized extensively by many financial firms in securitizations for off-balance sheet financing for "sale accounting" treatment in the transfer of financial assets. Currently, QSPEs do not have to be consolidated on the issuing firm's financial statements. Should the proposed changes to SFAS 140 become final, enterprises involved with QSPEs will no longer be exempt from applying FIN 46(R), the FASB Interpretation on consolidation; thus, previously unconsolidated entities may have to be consolidated. The revisions will also eliminate the provision in paragraph 9(b) of SFAS 140 that allowed entities to "look-through" to the rights of beneficial interest holders when analyzing control. Further, the revisions will address the derecognition of assets and amend the criteria for said derecognition; and require that the beneficial interests received by a transferor, in connection with a sale of an entire financial asset to an entity that is not consolidated by the transferor, be considered proceeds of the sale and initially measured at fair value.

Both financing and sale treatments have been used for GAAP reporting and tax treatment by the Company. FASB has released their Exposure Draft on the proposed amendments with comments due by November 14, 2008. The Company is currently reviewing the effect of these amendments on the Company.

In March 2008, the FASB issued SFAS No. 161, or SFAS 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement

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No. 133. SFAS 161 attempts to improve the transparency of financial reporting by providing additional information about how derivative and hedging activities affect an entity's financial position, financial performance and cash flows. This statement changes the disclosure requirements for derivative instruments and hedging activities by requiring enhanced disclosure about (1) how and why an entity uses derivative instruments, (2) how derivative instruments and related hedged items are accounted for under SFAS Statement 133 and its related interpretations, and (3) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. To meet these objectives, SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts and of gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. This disclosure framework is intended to better convey the purpose of derivative use in terms of the risks that an entity is intending to manage. SFAS 161 is effective for the Company on January 1, 2009. The Company expects that adoption of SFAS 161 will increase footnote disclosure to comply with the disclosure requirements for financial statements issued after January 1, 2009.

2. Mortgage-Backed Securities

The following table represents the Company's available for sale RMBS portfolio as of September 30, 2008 and December 31, 2007, at fair value.

	September 30, 2008	December 31, 2007

(dollars in thousands)		
Mortgage-Backed securities, at amortized cost	\$ 897,685	\$ 1,114,137
Gross unrealized gain	1,858	10,675
Gross unrealized loss	(140,165)	(522)

Fair value	\$ 759,378	\$ 1,124,290
=====		

During the quarter ended September 30, 2008, the Company had completed sales of assets with a carrying value of \$432.6 million in AAA-rated non-Agency RMBS which resulted in net realized losses of approximately \$113.1 million.

The following table presents the gross unrealized losses and estimated fair value of the Company's Mortgage-Backed Securities by length of time that such securities have been in a continuous unrealized loss position at September 30, 2008 and December 31, 2007.

	Unrealized Loss Position					
	For:					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Loss

(dollars in thousands)						
September 30, 2008	\$ 759,378	(\$140,165)	-	-	\$ 759,378	(\$140,165)
December 31, 2007	\$1,124,290	(\$522)	-	-	\$1,124,290	-

The decline in value of these securities is solely due to market conditions and not the credit quality of the assets. The investments are not considered

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other-than-temporarily impaired because the Company currently has the ability and intent to hold the investments to maturity or for a period of time sufficient for a forecasted market price recovery up to or beyond the cost of the investments.

Actual maturities of mortgage-backed securities are generally shorter than stated contractual maturities. Actual maturities of the Company's RMBS are affected by the contractual lives of the underlying mortgages, periodic payments of principal and prepayments of principal.

The following table summarizes the Company's RMBS at September 30, 2008 and December 31, 2007 according to their estimated weighted-average life classifications:

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	September 30, 2008 (dollars in thousands)	
Weighted Average Life	Fair Value	Amortized Cost
Less than one year	\$ -	\$ -
Greater than one year and less than five years	524,663	623,467
Greater than five years	234,715	274,218
Total	\$759,378	\$897,685

	December 31, 2007 (dollars in thousands)	
Weighted Average Life	Fair Value	Amortized Cost
Less than one year	\$ 45,868	\$ 46,102
Greater than one year and less than five years	1,078,422	1,068,035
Greater than five years	-	-
Total	\$1,124,290	\$1,114,137

The weighted-average lives of the mortgage-backed securities in the tables above are based on data provided through dealer quotes, assuming constant prepayment rates to the balloon or reset date for each security. The prepayment model considers current yield, forward yield, steepness of the curve, current mortgage rates, mortgage rates of the outstanding loan, loan age, margin and volatility.

3. Loans Held for Investment

The following table represents the Company's residential mortgage loans classified as held for investment at September 30, 2008 and December 31, 2007. At December 31, 2007, all of the adjustable rate loans held for investment were hybrid ARMs. Hybrid ARMs are mortgages that have interest rates that are fixed for an initial period (typically three, five, seven or 10 years) and thereafter reset at regular intervals subject to interest rate caps. The loans held for

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investment were carried at their principal balance outstanding less an allowance for loan losses:

	September 30, 2008	December 31, 2007

	(dollars in thousands)	
Mortgage loans, at principal balance	\$ -	\$ 162,
Less: allowance for loan losses	-	(

Mortgage loans held for investment	\$ -	\$ 162,
=====		

The following table summarizes the changes in the allowance for loan losses for the mortgage loan portfolio during the nine months ended September 30, 2008:

September 30, 2008	

(dollars in thousands)	
Balance, beginning of period	\$ 81
Provision for loan losses	465
Reversal of provision for loan losses	(546)

Balance, end of period	\$ -
=====	

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On a quarterly basis, the Company evaluates the adequacy of its allowance for loan losses. As of September 30, 2008, the Company had no residential mortgage loans held for investment and reversed the allowance for loan losses of \$546 thousand. As of December 31, 2007, the Company recorded an allowance for loan losses of \$81 thousand representing 5 basis points of the Company's mortgage loan portfolio.

During the quarter ended September 30, 2008, the Company sponsored a \$151.2 million securitization accounted for as a sale. In this transaction, the Company retained all securities issued by the securitization trust including approximately \$142.4 million of AAA-rated fixed and floating rate senior bonds and \$8.8 million in subordinated bonds. On August 28, 2008, the Company sold approximately \$74.9 million of the AAA-rated fixed and floating rate bonds related to this securitization to third-party investors, and realized a loss of \$11.6 million. The company retained the mezzanine tranche and various subordinate tranches in this transaction and classifies them as mortgage-backed securities, available for sale on its consolidated statement of financial condition.

During the nine months ended September 30, 2008, the Company sold \$97.7 million of loans held for investment and realized losses of \$6.9 million.

4. Securitized Loans Held for Investment

During the quarter ended June 30, 2008, the Company transferred \$619.7 million of its residential mortgage loans held for investment to the PHHMC 2008 CIM1 Trust in a securitization transaction. In this transaction, the Company sold \$536.9 million of AAA-rated fixed and floating rate bonds to third party investors and retained \$46.3 million of AAA-rated mezzanine bonds and \$36.5

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million in subordinated bonds which provide credit support to the certificates issued to third parties. The certificates issued by the trust are collateralized by loans held for investment that have been transferred to the PHMC 2008-CIM1 Trust. The Company incurred approximately \$1.4 million in issuance costs that were deducted from the proceeds of the transaction and are being amortized over the life of the bonds. This transaction was accounted for as a financing pursuant to SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

The following table represents the Company's securitized residential mortgage loans classified as held for investment at September 30, 2008. The Company did not hold any securitized loans at December 31, 2007. At September 30, 2008 approximately 55.5% of the Company's securitized loans are adjustable rate mortgage loans and 44.5% are fixed rate mortgage loans. All of the adjustable rate loans held for investment are hybrid ARMs. Hybrid ARMs are mortgages that have interest rates that are fixed for an initial period (typically three, five, seven or 10 years) and thereafter reset at regular intervals subject to interest rate caps. The loans held for investment are carried at their principal balance outstanding less an allowance for loan losses:

	September 30, 2008
(dollars in thousands)	
Securitized mortgage loans, at principal balance	\$ 598,695
Less: allowance for loan losses	(681)

Securitized mortgage loans held for investment	\$ 598,014
	=====

The following table summarizes the changes in the allowance for loan losses for the mortgage loan portfolio during the nine months ended September 30, 2008:

	September 30, 2008
(dollars in thousands)	
Balance, beginning of period	\$ -
Provision for loan losses	681

Balance, end of period	\$ 681
	=====

On a quarterly basis, the Company evaluates the adequacy of its allowance for loan losses. The Company maintained its allowance for loan losses for the quarter ended September 30, 2008 of \$681 thousand, representing 12 basis points of the principal balance of the Company's securitized mortgage loan portfolio. At September 30, 2008, there were no loans 60 days or more past due and all loans were accruing interest.

5. Fair Value Measurements

SFAS 157 defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

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Level 1 - valuation based on quoted prices for identical assets in active markets.

Level 2 - valuation based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3 - inputs to the valuation methodology are unobservable and significant to the overall fair value.

Mortgage-Backed Securities and interest rate swaps are valued using a pricing model. The MBS pricing model incorporates such factors as coupons, prepayment speeds, spread to the Treasury and swap curves, convexity, duration, periodic and life caps, and credit enhancement. Interest rate swaps are modeled by incorporating such factors as the Treasury curve, LIBOR rates, and the receive rate on the interest rate swaps. Management reviews the fair values determined by the pricing model and compares its results to dealer quotes received on investments to validate reasonableness of the valuations indicated by the pricing model. The dealer quotes will incorporate common market pricing methods, including a spread measurement to the Treasury curve or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security. The Company's financial assets and liabilities carried at fair value on a recurring basis are valued at September 30, 2008 as follows:

	Level 1	Level 2	Level 3
	(dollars in thousands)		

Assets:			
Mortgage-Backed Securities	\$ -	\$ 754,211	\$ 5,16

For investments classified above as Level 3, the Company recorded costs associated with the purchase of these assets in the amount of \$8.7 million and unrealized losses on the investments equal to \$3.5 million during the quarter ended September 30, 2008. Unrealized losses on the investments classified as Level 3 by the Company are included in the consolidated statement of operations as a component of other comprehensive income.

As fair value is not an entity specific measure and is a market based approach which considers the value of an asset or liability from the perspective of a market participant, observability of prices and inputs can vary significantly from period to period. During times of market dislocation, as has been experienced during the recent months, the observability of prices and inputs can be reduced for certain instruments. A condition such as this can cause instruments to be reclassified from level 1 to level 2 or level 2 to level 3.

6. Repurchase Agreements

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(A) Mortgage-Backed Securities

The Company had outstanding \$619.7 million and \$270.6 million of repurchase agreements with weighted average borrowing rates of 8.38% and 5.02% and weighted average remaining maturities of 1 and 22 days as of September 30, 2008 and

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December 31, 2007 respectively. At September 30, 2008, RMBS pledged as collateral under these repurchase agreements had an estimated fair value of \$736.8 million and a carrying value of \$619.8 million, including accrued interest. At December 31, 2007, RMBS pledged as collateral had an estimated fair value of \$271.7 million. The interest rates of these repurchase agreements are generally indexed to the one-month LIBOR rate and reprice accordingly.

At September 30, 2008 and December 31, 2007, the repurchase agreements collateralized by RMBS had the following remaining maturities:

	September 30, 2008	December 31, 2007

(dollars in thousands)		
Within 30 days	\$619,657	\$270,584
30 to 59 days	-	-
60 to 89 days	-	-
90 to 119 days	-	-
Greater than or equal to 120 days	-	-

Total	\$619,657	\$270,584
=====		

In March 2008, the Company entered into a RMBS repurchase agreement and a receivables sales agreement with Annaly. These agreements contain customary representations, warranties and covenants. As of September 30, 2008, the Company was financing \$619.7 million under the RMBS repurchase agreement.

At September 30, 2008, the Company had approximately 49% of equity at risk with Annaly. At December 31, 2007, the Company did not have an amount at risk greater than 10% of equity with any counterparty.

(B) Loans Held for Investment

The Company entered into two master repurchase agreements pursuant to which it financed mortgage loans. One agreement was a \$500 million lending facility of which \$200 million was on an uncommitted basis. This agreement was to be terminated January 16, 2009. The second agreement was a \$350 million committed lending facility. This agreement was to be terminated January 29, 2010. On July 29, 2008, the Company terminated both lending facilities. As of September 30, 2008 and December 31, 2007, the Company did not have any amounts borrowed against these facilities.

7. Securitized Debt

All of the Company's securitized debt is collateralized by residential mortgage loans. For financial reporting purposes, the Company's securitized debt is accounted for as a financing pursuant to SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Thus, the residential mortgage loans held as collateral are recorded in the assets of the Company as securitized loans and the securitized debt is recorded as a liability in the statement of financial condition.

At September 30, 2008, the securitized debt of the Company was collateralized by \$592.1 million of residential mortgage loans and has a principal balance of \$501 million. The debt matures between the years 2023 and 2038. At September 30, 2008 the debt carried a weighted average interest rate equal to 5.58%. At December 31, 2007 the Company had no securitized debt.

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8. Interest Rate Swaps

In connection with the Company's interest rate risk management strategy, the Company economically hedged a portion of its interest rate risk by entering into derivative financial instrument contracts. Generally, such instruments were comprised of interest rate swaps, which in effect modify the cash flows on repurchase agreements. The Company's swaps were used to lock-in a fixed rate relative to a portion of its current and anticipated future 30-day term repurchase agreements. The Company accounted for interest rate swaps as freestanding derivatives with changes in fair value recorded in earnings. During the quarter the Company terminated all of its interest rate swaps.

The table below represents the Company's swaps outstanding:

	Notional Amount	Weighted Average Pay Rate	Weighted Average Receive Rate

		(dollars in thousands)	
September 30, 2008	-	-	-
December 31, 2007	\$1,235,000	4.04%	4.94%

9. Common Stock

During the quarter ended September 30, 2008, the Company declared dividends to common shareholders totaling \$6.0 million or \$0.16 per share, which were paid on October 31, 2008.

On October 24, 2008 the Company announced the sale of 110,000,000 shares of common stock in a public offering at \$2.25 per share for estimated gross proceeds of approximately \$247.5 million. Immediately following the sale of these shares, Annaly Capital Management, Inc. purchased 11,681,415 shares at the same price per share as the public offering, for net proceeds of approximately \$26.3 million. In addition, on October 28, 2008 the underwriters exercised the option to purchase up to an additional 16,500,000 shares of common stock to cover overallotments for gross proceeds of approximately \$35.8 million. The Company estimates the total net proceeds from these offerings to be \$300 million.

10. Long Term Incentive Plan

The Company has adopted a long term stock incentive plan to provide incentives to its independent directors and employees of FIDAC and its affiliates, to stimulate their efforts towards the Company's continued success, long-term growth and profitability and to attract, reward and retain personnel and other service providers. The incentive plan authorizes the Compensation Committee of the board of directors to grant awards, including incentive stock options, non-qualified stock options, restricted shares and other types of incentive awards. The Incentive Plan authorizes the granting of options or other awards for an aggregate of the greater of 8.0% of the outstanding shares of the Company's common stock, or 3,119,431 shares, up to a ceiling of 40,000,000 shares.

As of September 30, 2008, the Company has granted restricted stock awards in the amount of 1,301,000 shares to FIDAC's employees and the Company's independent directors. Of these shares, 35,075 shares vested and 6,957 shares were forfeited or cancelled during the quarter ended September 30, 2008. For the nine months ended September 30, 2008, 108,675 shares vested and 13,670 shares were

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forfeited. The awards to the independent directors vested on the date of grant, and the awards to FIDAC's employees vest quarterly over a period of 10 years.

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At September 30, 2008 there are approximately 1.2 million unvested shares of restricted stock issued to employees of FIDAC. For the three months ended September 30, 2008, compensation expense less general and administrative costs associated with the amortization of the fair value of the restricted stock totaled \$254 thousand. For the nine months ended September 30, 2008 compensation expense less general and administrative costs associated with the amortization of the fair value of the restricted stock totaled \$1.3 million.

11. Income Taxes

As a REIT, the Company is not subject to Federal income tax on earnings distributed to its shareholders. Most states recognize REIT status as well. The Company has decided to distribute the majority of its income. During the quarter ended September 30, 2008, the Company recorded income tax expense of \$11,906 related to state and federal tax liabilities on undistributed income. For the nine months ended September 30, 2008, the Company recorded income tax expense of \$14,719.

12. Credit Risk and Interest Rate Risk

The Company's primary components of market risk are credit risk and interest rate risk. The Company is subject to credit risk in connection with its investments in residential mortgage loans and credit sensitive mortgage-backed securities. When the Company assumes credit risk, it attempts to minimize interest rate risk through asset selection, hedging and matching the income earned on mortgage assets with the cost of related liabilities. The Company is subject to interest rate risk, primarily in connection with its investments in fixed-rate and adjustable-rate mortgage backed securities, residential mortgage loans, and repurchase agreements. When the Company assumes interest rate risk, it minimizes credit risk through asset selection. The Company's strategy is to purchase loans underwritten to agreed-upon specifications of selected originators in an effort to mitigate credit risk. The Company has established a whole loan target market including prime borrowers with FICO scores generally greater than 650, Alt-A documentation, geographic diversification, owner-occupied property, moderate loan size and moderate loan to value ratio. These factors are considered to be important indicators of credit risk.

13. Management Agreement and Related Party Transactions

The Company has entered into a management agreement with FIDAC, which provides for an initial term through December 31, 2010 with automatic one-year extension options and subject to certain termination rights. The Company paid FIDAC a quarterly management fee equal to 1.75% per annum of the gross Stockholders' Equity (as defined in the management agreement) of the Company for the quarter ended September 30, 2008. Management fees accrued for the quarter ending September 30, 2008 are \$1.7 million. Management fees accrued for the nine months ended September 30, 2008 were \$6.1 million. At December 31, 2007 quarterly management fees in the amount of \$1.2 million were accrued and subsequently paid to FIDAC.

On October 13, 2008, the Company and FIDAC amended the management agreement to reduce the base management fee from 1.75% per annum to 1.50% per annum of the Company's stockholders' equity and provide that the incentive fees may be in cash or shares of the Company's common stock, at the election of the Company's board of directors.

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On October 19, 2008, the Company and FIDAC further amended the management agreement to provide that the incentive fee be eliminated in its entirety and FIDAC receive only the base management fee of 1.50% per annum of the Company's stockholders' equity.

The Company is obligated to reimburse FIDAC for its costs incurred under the management agreement. In addition, the management agreement permits FIDAC to require the Company to pay for its pro rata portion of rent, telephone, utilities, office furniture, equipment, machinery and other office, internal and overhead expenses of FIDAC incurred in the operation of the Company. These expenses are allocated between FIDAC and the Company based on the ratio of the Company's proportion of gross assets compared to all remaining gross assets managed by FIDAC as calculated at each quarter end. FIDAC and the Company will modify this allocation methodology, subject to the Company's board of directors' approval if the allocation becomes inequitable (i.e., if the Company becomes very highly leveraged compared to FIDAC's other funds and accounts). For the quarter ending September 30, 2008, FIDAC has waived its right to request reimbursement from the Company for these expenses.

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During the quarter ended September 30, 2008, 35,075 shares of restricted stock issued by the Company to FIDAC's employees vested, as discussed in Note 10.

In March 2008, the Company entered into a RMBS repurchase agreement and a receivables sales agreement with Annaly. These agreements contain customary representations, warranties and covenants. As of September 30, 2008, the Company was financing \$619.7 million under this agreement.

14. Commitments and Contingencies

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any reported or unreported contingencies at September 30, 2008.

15. Subsequent Events

On October 13, 2008, the Company and FIDAC amended the management agreement with FIDAC to reduce the base management fee from 1.75% per annum to 1.50% per annum of the Company's stockholders' equity and provide that the incentive fees may be paid in cash or shares of the Company's common stock, at the election of the Company's board of directors.

On October 19, 2008, the Company and FIDAC further amended the management agreement to provide that the incentive fee be eliminated in its entirety and the Manager receive only the base management fee of 1.50% per annum of the Company's stockholders' equity.

On October 24, 2008 the Company announced the sale of 110,000,000 shares of common stock in a public offering at \$2.25 per share for estimated gross proceeds of approximately \$247.5 million. Immediately following the sale of these shares, Annaly Capital Management, Inc. purchased 11,681,415 shares at the same price per share as the public offering, for net proceeds of approximately \$26.3 million. In addition, on October 28, 2008 the underwriters exercised the option to purchase up to an additional 16,500,000 shares of common stock to cover over-allotments for gross proceeds of approximately \$35.8 million. The Company estimates the total net proceeds from these offerings to be \$300 million.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

We make forward-looking statements in this report that are subject to risks and uncertainties. These forward-looking statements include information about possible or assumed future results of our business, financial condition, liquidity, results of operations, plans and objectives. When we use the words "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may," "would," "will" or similar expressions, we intend to identify forward-looking statements. Statements regarding the following subjects, among others, are forward-looking by their nature:

- o our business and investment strategy;
 - o our projected financial and operating results;
 - o our ability to maintain existing financing arrangements, obtain future financing arrangements and the terms of such arrangements;
 - o general volatility of the securities markets in which we invest;
 - o our expected investments;
 - o changes in the value of our investments;
 - o interest rate mismatches between our mortgage-backed securities and our borrowings used to fund such purchases;
 - o changes in interest rates and mortgage prepayment rates;
 - o effects of interest rate caps on our adjustable-rate mortgage-backed securities;
 - o rates of default or decreased recovery rates on our investments;
 - o prepayments of the mortgage and other loans underlying our mortgage-backed or other asset-backed securities;
 - o the degree to which our hedging strategies may or may not protect us from interest rate volatility;
 - o impact of and changes in governmental regulations, tax law and rates, accounting guidance, and similar matters;
 - o availability of investment opportunities in real estate-related and other securities;
 - o availability of qualified personnel;
 - o estimates relating to our ability to make distributions to our stockholders in the future;
 - o our understanding of our competition; and
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- o market trends in our industry, interest rates, the debt securities markets or the general economy.

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The forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. You should not place undue reliance on these forward-looking statements. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us. Some of these factors are described under the caption "Risk Factors" in our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made. New risks and uncertainties arise from time to time, and it is impossible for us to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Executive Summary

We are a specialty finance company that invests in residential mortgage loans, residential mortgage-backed securities, real estate related securities and various other asset classes. We are externally managed by FIDAC. We have elected and intend to qualify to be taxed as a REIT for federal income tax purposes commencing with our taxable year ending on December 31, 2007. Our targeted asset classes and the principal investments we expect to make in each are as follows:

- o RMBS, consisting of:
 - o Non-Agency RMBS, including investment-grade and non-investment grade classes, including the BB-rated, B-rated and non-rated classes
 - o Agency RMBS
- o Whole mortgage loans, consisting of:
 - o Prime mortgage loans
 - o Jumbo prime mortgage loans
 - o Alt-A mortgage loans
- o Asset Backed Securities, or ABS, consisting of:
 - o CMBS
 - o Debt and equity tranches of CDOs
 - o Consumer and non-consumer ABS, including investment-grade and non-investment grade classes, including the BB-rated, B-rated and non-rated classes

We completed our initial public offering on November 21, 2007. In that offering and in a concurrent private offering we raised net proceeds before offering expenses of approximately \$533.6 million. We completed a second public offering and second private offering on October 29, 2008. In these offerings we raised proceeds before offering expenses of approximately \$309.6 million and we are commencing investing these proceeds.

Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, primarily through dividends and secondarily

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through capital appreciation. We intend to achieve this objective by investing in a broad class of financial assets to construct an investment portfolio that is designed to achieve attractive risk-adjusted returns and that is structured to comply with the various federal income tax requirements for REIT status. We expect that over the near term our investment portfolio will continue to be weighted toward non-Agency RMBS, subject to maintaining our REIT qualification and our 1940 Act exemption, which may, depending on the composition of our investment portfolio, require us to purchase Agency RMBS or other qualifying assets. Over time we expect that our investment portfolio will become more weighted toward residential mortgage loans.

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Our investment strategy is intended to take advantage of opportunities in the current interest rate and credit environment. We will adjust our strategy to changing market conditions by shifting our asset allocations across these various asset classes as interest rate and credit cycles change over time. We believe that our strategy, combined with FIDAC's experience, will enable us to pay dividends and achieve capital appreciation throughout changing market cycles. We expect to take a long-term view of assets and liabilities, and our reported earnings and mark-to-market valuations at the end of a financial reporting period will not significantly impact our objective of providing attractive risk-adjusted returns to our stockholders over the long-term.

We use leverage to seek to increase our potential returns and to fund the acquisition of our assets. Our income is generated primarily by the difference, or net spread, between the income we earn on our assets and the cost of our borrowings. We expect to finance our investments using a variety of financing sources including repurchase agreements, warehouse facilities, securitizations, commercial paper and term financing CDOs. We may manage our debt by utilizing interest rate hedges, such as interest rate swaps, to reduce the effect of interest rate fluctuations related to our debt.

Recent Developments

We commenced operations in November 2007 in the midst of challenging market conditions which affected the cost and availability of financing from the facilities with which we expected to finance our investments. These instruments included repurchase agreements, warehouse facilities, securitizations, asset-backed commercial paper, or ABCP, and term CDOs. The liquidity crisis which commenced in August 2007 affected each of these sources--and their individual providers--to different degrees; some sources generally became unavailable, some remained available but at a high cost, and some were largely unaffected. For example, in the repurchase agreement market, non-Agency RMBS became harder to finance, depending on the type of assets collateralizing the RMBS. The amount, term and margin requirements associated with these types of financings were also impacted. At that time, warehouse facilities to finance whole loan prime residential mortgages were generally available from major banks, but at significantly higher cost and had greater margin requirements than previously offered. It was also extremely difficult to term finance whole loans through securitization or bonds issued by a CDO structure. Financing using ABCP froze as issuers became unable to place (or roll) their securities, which resulted, in some instances, in forced sales of mortgage-backed securities, or MBS, and other securities which further negatively impacted the market value of these assets.

Although the credit markets had been undergoing much turbulence, as we started ramping up our portfolio, we noted a slight easing. We entered into a number of repurchase agreements we could use to finance RMBS. In January 2008, we entered into two whole mortgage loan repurchase agreements. As we began to see the availability of financing, we were also seeing better underwriting

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standards used to originate new mortgages. We commenced buying and financing RMBS and also entered into agreements to purchase whole mortgage loans. We purchased high credit quality assets which we believed we would be readily able to finance.

Beginning in mid-February 2008, credit markets experienced a dramatic and sudden adverse change. The severity of the limitation on liquidity was largely unanticipated by the markets. Credit once again froze, and in the mortgage market, valuations of non-Agency RMBS and whole mortgage loans came under severe pressure. This credit crisis began in early February 2008, when a heavily leveraged investor announced that it had to de-lever and liquidate a portfolio of approximately \$30 billion of non-Agency RMBS. Prices of these types of securities dropped dramatically, and lenders started lowering the prices on non-Agency RMBS that they held as collateral to secure the loans they had extended. The subsequent failure in March 2008 of a major investment bank worsened the crisis. During the past nine months, due to the deterioration in the market value of our assets, we received and met margin calls under our repurchase agreements, which resulted in our obtaining additional funding from third parties, including from Annaly, and taking other steps to increase our liquidity. Additionally, the disruptions during the six months ended June 30, 2008 resulted in us not being in compliance with the net income covenant in one of our whole loan repurchase agreements and the liquidity covenants in our other whole loan repurchase agreement at a time during which we had no amounts outstanding under those facilities. We amended these covenants, and on July 29, 2008, we terminated those facilities to avoid paying non-usage fees. Although we made no asset sales during the quarter ended June 30, 2008, for the third quarter of 2008, we sold assets with a carrying value of \$432.6 million in AAA-rated non-Agency RMBS for a loss of approximately \$113.1 million, which includes a realized loss of \$11.6 million related to the August 28, 2008 transaction described below, and terminated \$983.4 million in notional interest rate swaps for a loss of approximately \$10.5 million, which together resulted in a net realized loss of approximately \$123.6 million.

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The challenges of the first quarter of 2008 have continued into the second and third quarters, as financing difficulties have severely pressured liquidity and asset values. In September 2008, Lehman Brothers Holdings, Inc., a major investment bank, experienced a major liquidity crisis and failed. Securities trading remains limited and mortgage securities financing markets remain challenging as the industry continues to report negative news. This dislocation in the non-Agency mortgage sector has made it difficult for us to obtain short-term financing on favorable terms. As a result, we have completed loan securitizations in order to obtain long-term financing and terminated our un-utilized whole loan repurchase agreements in order to avoid paying non-usage fees under those agreements. In addition, we have continued to seek funding from Annaly. Under these circumstances, we expect to take actions intended to protect our liquidity, which may include reducing borrowings and disposing of assets as well as raising capital as we recently did. As a result, we expect to operate with a low level of leverage and to continue to take actions that would support available cash.

During this period of market dislocation, fiscal and monetary policymakers have established new liquidity facilities for primary dealers and commercial banks, reduced short-term interest rates, and passed legislation that is intended to address the challenges of mortgage borrowers and lenders. This legislation, the Housing and Economic Recovery Act of 2008, seeks to forestall home foreclosures for distressed borrowers and assist communities with foreclosure problems. Although these aggressive steps are intended to protect and support the US housing and mortgage market, we continue to operate under very difficult market conditions.

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Since June 30, 2008, there have been increased market concerns about Freddie Mac and Fannie Mae's ability to withstand future credit losses associated with securities held in their investment portfolios, and on which they provide guarantees, without the direct support of the federal government. Recently, the government passed the "Housing and Economic Recovery Act of 2008." Fannie Mae and Freddie Mac have recently been placed into the conservatorship of the Federal Housing Finance Agency, or FHFA, their federal regulator, pursuant to its powers under The Federal Housing Finance Regulatory Reform Act of 2008, a part of the Housing and Economic Recovery Act of 2008. As the conservator of Fannie Mae and Freddie Mac, the FHFA controls and directs the operations of Fannie Mae and Freddie Mac and may (1) take over the assets of and operate Fannie Mae and Freddie Mac with all the powers of the shareholders, the directors, and the officers of Fannie Mae and Freddie Mac and conduct all business of Fannie Mae and Freddie Mac; (2) collect all obligations and money due to Fannie Mae and Freddie Mac; (3) perform all functions of Fannie Mae and Freddie Mac which are consistent with the conservator's appointment; (4) preserve and conserve the assets and property of Fannie Mae and Freddie Mac; and (5) contract for assistance in fulfilling any function, activity, action or duty of the conservator.

In addition to FHFA becoming the conservator of Fannie Mae and Freddie Mac, (i) the U.S. Department of Treasury and FHFA have entered into preferred stock purchase agreements between the U.S. Department of Treasury and Fannie Mae and Freddie Mac pursuant to which the U.S. Department of Treasury will ensure that each of Fannie Mae and Freddie Mac maintains a positive net worth; (ii) the U.S. Department of Treasury has established a new secured lending credit facility which will be available to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, which is intended to serve as a liquidity backstop, which will be available until December 2009; and (iii) the U.S. Department of Treasury has initiated a temporary program to purchase RMBS issued by Fannie Mae and Freddie Mac. Given the highly fluid and evolving nature of these events, it is unclear how our business will be impacted. Based upon the further activity of the U.S. government or market response to developments at Fannie Mae or Freddie Mac, our business could be adversely impacted.

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The Emergency Economic Stabilization Act of 2008, or EESA, was recently enacted. The EESA provides the U.S. Secretary of the Treasury with the authority to establish a Troubled Asset Relief Program, or TARP, to purchase from financial institutions up to \$700 billion of residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, as well as any other financial instrument that the U.S. Secretary of the Treasury, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, upon transmittal of such determination, in writing, to the appropriate committees of the U.S. Congress. The EESA also provides for a program that would allow companies to insure their troubled assets.

There can be no assurance that the EESA will have a beneficial impact on the financial markets, including current extreme levels of volatility. To the extent the market does not respond favorably to the TARP or the TARP does not function as intended, our business may not receive the anticipated positive impact from the legislation. In addition, the U.S. Government, Federal Reserve and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. We cannot predict whether or when such actions may occur or what impact, if any, such actions could have on our business, results of operations and financial condition.

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On July 25, 2008, we sponsored a \$151.2 million securitization whereby we securitized our then-current inventory of mortgage loans. In this transaction, we retained all of the securities issued by the securitization trust including approximately \$142.4 million of AAA-rated fixed and floating rate senior bonds and \$8.8 million in subordinated bonds. This transaction will be accounted for as a sale. On August 28, 2008, we sold approximately \$74.9 million of the AAA-rated fixed and floating rate bonds related to the July 25, 2008 securitization to third-party investors and realized a loss of \$11.6 million.

On September 9, 2008, we declared the third quarter 2008 common stock cash dividend of \$0.16 per share of our common stock. This dividend is payable October 31, 2008 to common shareholders of record on September 18, 2008.

In October 2008, we and FIDAC amended our management agreement to reduce the base management fee from 1.75% per annum to 1.50% per annum of our stockholders' equity and eliminate the incentive fees previously provided for in the management agreement.

Trends

We expect the results of our operations to be affected by various factors, many of which are beyond our control. Our results of operations will primarily depend on, among other things, the level of our net interest income, the market value of our assets, and the supply of and demand for such assets. Our net interest income, which reflects the amortization of purchase premiums and accretion of discounts, varies primarily as a result of changes in interest rates, borrowing costs, and prepayment speeds, which is a measurement of how quickly borrowers pay down the unpaid principal balance on their mortgage loans.

Prepayment Speeds. Prepayment speeds, as reflected by the Constant Prepayment Rate, or CPR, vary according to interest rates, the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, when interest rates rise, it is relatively less attractive for borrowers to refinance their mortgage loans, and as a result, prepayment speeds tend to decrease. When interest rates fall, prepayment speeds tend to increase. For mortgage loan and RMBS investments purchased at a premium, as prepayment speeds increase, the amount of income we earn decreases because the purchase premium we paid for the bonds amortizes faster than expected. Conversely, decreases in prepayment speeds result in increased income and can extend the period over which we amortize the purchase premium. For mortgage loan and RMBS investments purchased at a discount, as prepayment speeds increase, the amount of income we earn increases because of the acceleration of the accretion of the discount into interest income. Conversely, decreases in prepayment speeds result in decreased income and can extend the period over which we accrete the purchase discount into interest income.

Rising Interest Rate Environment. As indicated above, as interest rates rise, prepayment speeds generally decrease, increasing our net interest income. Rising interest rates, however, increase our financing costs which may result in a net negative impact on our net interest income. In addition, if we acquire Agency and non-Agency RMBS collateralized by monthly reset adjustable-rate mortgages, or ARMs, and three- and five-year hybrid ARMs, such interest rate increases could result in decreases in our net investment income, as there could be a timing mismatch between the interest rate reset dates on our RMBS portfolio and the financing costs of these investments. Monthly reset ARMs are ARMs on which coupon rates reset monthly based on indices such as the one-month London

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Interbank Offering Rate, or LIBOR. Hybrid ARMs are mortgages that have interest rates that are fixed for an initial period (typically three, five, seven or ten years) and thereafter reset at regular intervals subject to interest rate caps.

With respect to our floating rate investments, such interest rate increases should result in increases in our net investment income because our floating rate assets are greater in amount than the related floating rate liabilities. Similarly, such an increase in interest rates should generally result in an increase in our net investment income on fixed-rate investments made by us because our fixed-rate assets would be greater in amount than our fixed-rate liabilities. We expect, however, that our fixed-rate assets would decline in value in a rising interest rate environment and that our net interest spreads on fixed rate assets could decline in a rising interest rate environment to the extent such assets are financed with floating rate debt.

Falling Interest Rate Environment. As interest rates fall, prepayment speeds generally increase, decreasing our net interest income. Falling interest rates, however, decrease our financing costs which may result in a net positive impact on our net interest income. In addition, if we acquire Agency and non-Agency RMBS collateralized by monthly reset adjustable-rate mortgages, or ARMs, and three- and five-year hybrid ARMs, such interest rate decreases could result in increases in our net investment income, as there could be a timing mismatch between the interest rate reset dates on our RMBS portfolio and the financing costs of these investments. Monthly reset ARMs are ARMs on which coupon rates reset monthly based on indices such as the one-month London Interbank Offering Rate, or LIBOR. Hybrid ARMs are mortgages that have interest rates that are fixed for an initial period (typically three, five, seven or ten years) and thereafter reset at regular intervals subject to interest rate caps.

With respect to our floating rate investments, such interest rate decreases may result in decreases in our net investment income because our floating rate assets may be greater in amount than the related floating rate liabilities. Similarly, such a decrease in interest rates should generally result in an increase in our net investment income on fixed-rate investments made by us because our fixed-rate assets would be greater in amount than our fixed-rate liabilities. We expect, however, that our fixed-rate assets would increase in value in a falling interest rate environment and that our net interest spreads on fixed rate assets could increase in a falling interest rate environment to the extent such assets are financed with floating rate debt.

Credit Risk. One of our strategic focuses is acquiring assets which we believe to be of high credit quality. We believe this strategy will generally keep our credit losses and financing costs low. We retain the risk of potential credit losses on all of the residential mortgage loans we hold in our portfolio. Additionally, some of our investments in RMBS may be qualifying interests for purposes of maintaining our exemption from the 1940 Act because we retain a 100% ownership interest in the underlying loans. If we purchase all classes of these securitizations, we have the credit exposure on the underlying loans. Prior to the purchase of these securities, we conduct a due diligence process that allows us to remove loans that do not meet our credit standards based on loan-to-value ratios, borrowers' credit scores, income and asset documentation and other criteria that we believe to be important indications of credit risk.

Size of Investment Portfolio. The size of our investment portfolio, as measured by the aggregate unpaid principal balance of our mortgage loans and aggregate principal balance of our mortgage related securities and the other assets we own is also a key revenue driver. Generally, as the size of our investment portfolio grows, the amount of interest income we receive increases. The larger investment portfolio, however, drives increased expenses as we incur additional interest expense to finance the purchase of our assets.

Since changes in interest rates may significantly affect our

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activities, our operating results depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT.

Current Environment. The current weakness in the broader mortgage markets could adversely affect one or more of our potential lenders or any of our lenders and could cause one or more of our potential lenders or any of our lenders to be unwilling or unable to provide us with financing or require us to post additional collateral. In general, this could potentially increase our financing costs and reduce our liquidity or require us to sell assets at an inopportune time. We expect to use a number of sources to finance our investments, including repurchase agreements, warehouse facilities, securitizations, asset-backed commercial paper and term CDOs. Current market conditions have affected the cost and availability of financing from each of these sources and their individual providers to different degrees; some sources generally are unavailable, some are available but at a high cost, and some are largely unaffected. For example, in the repurchase agreement market, borrowers have been affected differently depending on the type of security they are financing. Non-Agency RMBS have been harder to finance, depending on the type of assets collateralizing the RMBS. The amount, term and margin requirements associated with these types of financings have been negatively impacted.

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Currently, warehouse facilities to finance whole loan prime residential mortgages are generally available from major banks, but at significantly higher cost and have greater margin requirements than previously offered. Many major banks that offer warehouse facilities have also reduced the amount of capital available to new entrants and consequently the size of those facilities offered now are smaller than those previously available. We decided to terminate our two whole loan repurchase agreements in order to avoid paying non-usage fees under those agreements.

It is currently a challenging market to term finance whole loans through securitization or bonds issued by a CDO structure. The highly rated senior bonds in these securitizations and CDO structures currently have liquidity, but at much wider spreads than issues priced in recent history. The junior subordinate tranches of these structures currently have few buyers and current market conditions have forced issuers to retain these lower rated bonds rather than sell them.

Certain issuers of ABCP have been unable to place (or roll) their securities, which has resulted, in some instances, in forced sales of MBS and other securities which has further negatively impacted the market value of these assets. These market conditions are fluid and likely to change over time. As a result, the execution of our investment strategy may be dictated by the cost and availability of financing from these different sources.

If one or more major market participants fails or otherwise experiences a major liquidity crisis, as was the case for Bear Stearns & Co. in March 2008, and Lehman Brothers Holdings Inc. in September 2008, it could negatively impact the marketability of all fixed income securities and this could negatively impact the value of the securities we acquire, thus reducing our net book value. Furthermore, if many of our potential lenders or any of our lenders are unwilling or unable to provide us with financing, we could be forced to sell our securities or residential mortgage loans at an inopportune time when prices are depressed. For example, for the quarter ended March 31, 2008, we sold assets with a carrying value of \$394.2 million for an aggregate loss of \$32.8 million. While we did not sell any assets during the quarter ended June 30, 2008, for the third quarter of 2008, we sold assets with a carrying value of \$432.6 million in AAA-rated non-Agency RMBS for a loss of approximately \$113.1 million and

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terminated \$983.4 million in notional interest rate swaps for a loss of approximately \$10.5 million, which together resulted in a net realized loss of approximately \$123.6 million.

As described above, there has been significant government action in the capital markets. However, there can be no assurance that the government's actions with respect to Freddie Mac and Fannie Mae, the EESA, or the TARP will have a beneficial impact on the financial markets, including current extreme levels of volatility. To the extent the market does not respond favorably to these actions, or these actions do not function as intended, our business may not receive the anticipated positive impact from them. In addition, the U.S. Government, Federal Reserve and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. We cannot predict whether or when such actions may occur or what impact, if any, such actions could have on our business, results of operations and financial condition.

In the current market, it may be difficult or impossible to obtain third party pricing on the investments we purchase. In addition, validating third party pricing for our investments may be more subjective as fewer participants may be willing to provide this service to us. Moreover, the current market is more illiquid than in recent history for some of the investments we purchase. Illiquid investments typically experience greater price volatility as a ready market does not exist. As volatility increases or liquidity decreases we may have greater difficulty financing our investments which may negatively impact our earnings and the execution of our investment strategy.

Critical Accounting Policies

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. These accounting principles may require us to make some complex and subjective decisions and assessments. Our most critical accounting policies will involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our financial statements are based will be reasonable at the time made and based upon information available to us at that time. At each quarter end, we calculate estimated fair value using a pricing model. We validate our pricing model by obtaining independent pricing on all of our assets and performing a verification of those sources to our own internal estimate of fair value. We have identified what we believe will be our most critical accounting policies to be the following:

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Valuation of Investments

On January 1, 2008, we adopted SFAS 157, which defines fair value, establishes a framework for measuring fair value, and establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

Level 1 - valuation based on quoted prices for identical assets in active markets.

Level 2 - valuation based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

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Level 3 - inputs to the valuation methodology are unobservable and significant to overall fair value.

Mortgage-Backed Securities and interest rate swaps are valued using a pricing model. The MBS pricing model incorporates such factors as coupons, prepayment speeds, spread to the Treasury and swap curves, convexity, duration, periodic and life caps, and credit enhancement. Interest rate swaps are modeled by incorporating such factors as the Treasury curve, LIBOR rates, and the receive rate on the interest rate swaps. Management reviews the fair values determined by the pricing model and compares its results to dealer quotes received on each investment to validate the reasonableness of the valuations indicated by the pricing models. The dealer quotes will incorporate common market pricing methods, including a spread measurement to the Treasury curve or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security.

As fair value is not an entity specific measure and is a market based approach which considers the value of an asset or liability from the perspective of a market participant, observability of prices and inputs can vary significantly from period to period. During times of market dislocation, as has been experienced during the recent months, the observability of prices and inputs can be reduced for certain instruments. A condition such as this can cause instruments to be reclassified from level 1 to level 2 or level 2 to level 3. At September 30, 2008 we held \$5.2 million of investments we classify as Level 3; the remainder of our investments are classified as Level 2.

Loans Held for Investment and Securitized Loans Held to Maturity

We purchase residential mortgage loans and classify them as loans held for investment or Securitized loans held to maturity on the statement of financial condition. These investments are intended to be held to maturity and, accordingly, are reported at the principal amount outstanding, net of provisions for loan losses.

Loan loss provisions are examined quarterly and updated to reflect expectations of future probable credit losses based on factors such as originator historical losses, geographic concentration, individual loan characteristics, experienced losses, and expectations of future loan pool behavior. As credit losses occur, the provision for loan losses will reflect that realization.

When we determine that it is probable that contractually due specific amounts are deemed uncollectable, the loan is considered impaired. To measure our impairment we determine the excess of the recorded investment amount over the net fair value of the collateral, as reduced by selling costs. Any deficiency between the carrying amount of an asset and the net sales price of repossessed collateral is charged to the allowance for loan losses.

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An allowance for mortgage loans is maintained at a level believed adequate by management to absorb probable losses. We may elect to sell a loan held for investment due to adverse changes in credit fundamentals. Once the determination has been made by us that we will no longer hold the loan for investment, we will account for the loan at the lower of amortized cost or estimated fair value. The reclassification of the loan and recognition of impairments could adversely affect our reported earnings.

Valuations of Available-for-Sale Securities

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We expect our investments in RMBS will be primarily classified as available-for-sale securities that are carried on the statement of financial condition at their fair value. This classification will result in changes in fair values being recorded as statement of financial condition adjustments to accumulated other comprehensive income or loss, which is a component of stockholders' equity.

Our available-for-sale securities have fair values as determined with reference to fair values calculated using a pricing model. Management reviews the fair values generated to insure prices are reflective of the current market. We perform a validation of the fair value calculated by the pricing model by comparing its results to independent prices provided by dealers in the securities and/or third party pricing services. If dealers or independent pricing services are unable to provide a price for an asset, or if the price provided by them is deemed unreliable by FIDAC, then the asset will be valued at its fair value as determined in good faith by FIDAC. The pricing is subject to various assumptions which could result in different presentations of value.

When the fair value of an available-for-sale security is less than its amortized cost for an extended period or there is a significant decline in value, we consider whether there is an other-than-temporary impairment in the value of the security. If, based on our analysis, an other-than-temporary impairment exists, the cost basis of the security is written down to the then-current fair value, and the unrealized loss is transferred from accumulated other comprehensive loss as an immediate reduction of current earnings (as if the loss had been realized in the period of other-than-temporary impairment). The determination of other-than-temporary impairment is a subjective process, and different judgments and assumptions could affect the timing of loss realization.

We consider the following factors when determining an other-than-temporary impairment for a security:

- o The length of time and the extent to which the market value has been less than the amortized cost;
- o Whether the security has been downgraded by a rating agency; and
- o Our intent to hold the security for a period of time sufficient to allow for any anticipated recovery in market value.

The determination of other-than-temporary impairment is made at least quarterly. If we determine an impairment to be other than temporary we will realize a loss which will negatively impact current income.

Investment Consolidation

For each investment we make, we will evaluate the underlying entity that issued the securities we will acquire or to which we will make a loan to determine the appropriate accounting. In performing our analysis, we refer to guidance in Statement of Financial Accounting Standards (SFAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and FASB Interpretation No. (FIN) 46R, Consolidation of Variable Interest Entities. FIN 46R addresses the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements, to certain entities in which voting rights are not effective in identifying an investor with a controlling financial interest. In variable interest entities, or VIEs, an entity is subject to consolidation under FIN 46R if the investors either do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, are unable to direct the entity's activities, or are not exposed to the entity's losses or entitled to its residual returns. VIEs within the scope of FIN 46R are required to be consolidated by their primary

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beneficiary. The primary beneficiary of a VIE is determined to be the party that absorbs a majority of the entity's expected losses, its expected returns, or both. This determination can sometimes involve complex and subjective analyses.

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Interest Income Recognition

Interest income on available-for-sale securities and loans held for investment is recognized over the life of the investment using the effective interest method as described by SFAS No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, for securities of high credit quality and Emerging Issues Task Force No. 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets, for all other securities. Income recognition is suspended for loans when, in the opinion of management, a full recovery of income and principal becomes doubtful. Income recognition is resumed when the loan becomes contractually current and performance is demonstrated to be resumed.

Under SFAS No. 91 and Emerging Issues Task Force No. 99-20, management will estimate, at the time of purchase, the future expected cash flows and determine the effective interest rate based on these estimated cash flows and our purchase price. As needed, these estimated cash flows will be updated and a revised yield computed based on the current amortized cost of the investment. In estimating these cash flows, there will be a number of assumptions that will be subject to uncertainties and contingencies. These include the rate and timing of principal payments (including prepayments, repurchases, defaults and liquidations), the pass-through or coupon rate and interest rate fluctuations. In addition, interest payment shortfalls due to delinquencies on the underlying mortgage loans, and the timing of the magnitude of credit losses on the mortgage loans underlying the securities have to be judgmentally estimated. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management's estimates and our interest income.

Accounting For Derivative Financial Instruments

Our policies permit us to enter into derivative contracts, including interest rate swaps and interest rate caps, as a means of mitigating our interest rate risk. We intend to use interest rate derivative instruments to mitigate interest rate risk rather than to enhance returns.

We account for derivative financial instruments in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted. SFAS No. 133 requires an entity to recognize all derivatives as either assets or liabilities in the statement of financial condition and to measure those instruments at fair value. Additionally, the fair value adjustments will affect either other comprehensive income in stockholders' equity until the hedged item is recognized in earnings or net income depending on whether the derivative instrument qualifies as a hedge for accounting purposes and, if so, the nature of the hedging activity. We have elected not to qualify for hedge accounting treatment. As a result, our operating results may suffer because losses on the derivatives that we enter into may not be offset by a change in the fair value of the related hedged transaction.

In the normal course of business, we may use a variety of derivative financial instruments to economically manage, or hedge, interest rate risk. These derivative financial instruments must be effective in reducing our interest rate risk exposure in order to qualify for hedge accounting. When the terms of an underlying transaction are modified, or when the underlying hedged item ceases to exist, all changes in the fair value of the instrument are

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included in net income for each period until the derivative instrument matures or is settled. Any derivative instrument used for risk management that does not meet the hedging criteria is carried at fair value with the changes in value included in net income.

Derivatives will be used for economic hedging purposes rather than speculation. We will rely on quotations from third parties to determine fair values. If our hedging activities do not achieve our desired results, our reported earnings may be adversely affected. We hold no derivatives at September 30, 2008.

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Reserve for Possible Credit Losses

The expense for possible credit losses in connection with debt investments is the charge to earnings to increase the allowance for possible credit losses to the level that management estimates to be adequate considering delinquencies, loss experience and collateral quality. Other factors considered relate to geographic trends and product diversification, the size of the portfolio and current economic conditions. Based upon these factors, we establish the provision for possible credit losses by category of asset. When it is probable that we will be unable to collect all amounts contractually due, the account is considered impaired.

Where impairment is indicated, a valuation write-down or write-off is measured based upon the excess of the recorded investment amount over the net fair value of the collateral, as reduced by selling costs. Any deficiency between the carrying amount of an asset and the net sales price of repossessed collateral is charged to the allowance for credit losses.

Income Taxes

The Company has elected and intends to qualify to be taxed as a REIT. Accordingly, we will generally not be subject to corporate federal or state income tax to the extent that we make qualifying distributions to our stockholders, and provided we satisfy on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which we lost our REIT qualification. Accordingly, our failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to our stockholders.

The dividends paid deduction of a REIT for qualifying dividends to its stockholders is computed using our taxable income as opposed to net income reported on the financial statements. Taxable income, generally, will differ from net income reported on the financial statements because the determination of taxable income is based on tax provisions and not financial accounting principles.

In the future, we may create subsidiaries and treat them as taxable REIT subsidiaries, or TRSs. In general, a TRS of ours may hold assets and engage in activities that we cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to federal, state and local corporate income taxes.

While our TRS will generate net income, our TRS can declare dividends to us which will be included in our taxable income and necessitate a

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distribution to our stockholders. Conversely, if we retain earnings at the TRS level, no distribution is required and we can increase book equity of the consolidated entity.

Financial Condition

At September 30, 2008, our portfolio consisted of \$759.4 million of RMBS and of approximately \$598 million of securitized mortgage loans.

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The following table summarizes certain characteristics of our portfolio at September 30, 2008 and December 31, 2007.

	September 30, 2008

Leverage at period-end	4.6:1
Residential mortgage-backed securities as a % of portfolio	60.4%
Residential mortgage loans as a % of portfolio	-
Loans collateralizing secured debt as a % of portfolio	39.6%
Fixed-rate investments as % of portfolio	18.4%
Adjustable-rate investments as % of portfolio	81.6%
Fixed-rate investments	
Residential mortgage-backed securities as a % of fixed-rate assets	4.4%
Residential mortgage loans as a % of fixed-rate assets	-
Loans collateralizing secured debt as a % of fixed-rate assets	95.6%
Adjustable-rate investments	
Residential mortgage-backed securities as a % of adjustable-rate assets	73.0%
Residential mortgage loans as a % of adjustable-rate assets	-
Loans collateralizing secured debt as a % of adjustable-rate assets	27.0%
Annualized yield on average earning assets during the period	5.35%
Annualized cost of funds on average repurchase agreements balance during the period	4.64%
Annualized interest rate spread during the period	0.71%
Weighted average yield on assets at period-end	5.63%
Weighted average cost of funds at period-end	7.10%

Residential Mortgage-Backed Securities

The table below summarizes our RMBS investments at September 30, 2008 and December 31, 2007:

	September 30, 2008	December 31, 2007
	(dollars in thousands)	

Amortized cost	\$897,685	\$1,114,137
Unrealized gains	1,858	10,675
Unrealized losses	(140,165)	(522)

Fair value	\$759,378	\$1,124,290
	=====	

As of September 30, 2008, the RMBS in our portfolio were purchased at a net discount to their par value. Our RMBS had a weighted average amortized cost of 99.4% and 98.8% at September 30, 2008 and December 31, 2007, respectively.

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The following tables summarize certain characteristics of our RMBS portfolio at September 30, 2008 and December 31, 2007.

	Estimated Value (dollars in thousands) (1)	Coupon	Weighted Averages Yield to Maturity	Constant Prepayment Rate (2)

September 30, 2008	\$759,378	5.99%		