

Edgar Filing: ANNALY CAPITAL MANAGEMENT INC - Form 10-Q

ANNALY CAPITAL MANAGEMENT INC  
Form 10-Q  
August 08, 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: JUNE 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

ANNALY CAPITAL MANAGEMENT, INC.  
(Exact name of Registrant as specified in its Charter)

MARYLAND  
(State or other jurisdiction  
of incorporation or organization)

22-3479661  
(IRS Employer Identification No.)

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

10036  
(Zip Code)

(212) 696-0100  
(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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" 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 August 8, 2008 |
|-------------------------------|-------------------------------|
| Common Stock, \$.01 par value | 538,549,916                   |

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

### FORM 10-Q

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Part I  
Item 1. Financial Statements

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
(dollars in thousands, except for share data)

|   | (Unaudited)<br>June 30, 2008 | Dec<br>2 |
|---|------------------------------|----------|
| ASSETS  |                              |          |
| Cash and cash equivalents   | \$1,462,737                  |          |
| Reverse repurchase agreements   | 49,964                       |          |
| Mortgage-Backed Securities, at fair value   | 58,017,305                   |          |
| Agency debentures, at fair value  | 731,995                      |          |
| Available for sale equity securities, at fair value   | 32,631                       |          |
| Trading securities, at fair value   | 23,478                       |          |
| Receivable for Mortgage-Backed Securities sold  | 824,308                      |          |
| Accrued interest and dividends receivable   | 303,228                      |          |
| Receivable for advisory and service fees  | 4,703                        |          |
| Intangible for customer relationships, net  | 7,604                        |          |
| Goodwill  | 22,966                       |          |
| Other assets  | 3,216                        |          |
|   | -----                        |          |
| Total assets  | \$61,484,135                 |          |
|   | =====                        |          |
| LIABILITIES AND STOCKHOLDERS' EQUITY  |                              |          |
| -----   |                              |          |
| Liabilities:  |                              |          |
| Repurchase agreements   | \$51,839,663                 | \$       |
| Payable for Investment Securities purchased   | 1,405,109                    |          |
| Trading securities sold, not yet purchased, at fair value   | 48,718                       |          |
| Accrued interest payable  | 154,615                      |          |
| Dividends payable   | 296,201                      |          |
| Accounts payable and other liabilities  | 36,625                       |          |
| Interest rate swaps, at fair value  | 400,998                      |          |
|   | -----                        |          |
| Total liabilities   | 54,181,929                   |          |
|   | -----                        |          |
| Minority interest in equity of consolidated affiliate   | -                            |          |
|   | -----                        |          |
| 6.00% Series B Cumulative Convertible Preferred Stock:<br>4,600,000 shares authorized, 4,496,525 and 4,600,000 shares issued<br>and outstanding | 108,957                      |          |
|   | -----                        |          |
| Commitments and contingencies (Note 12)   | -                            |          |

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|  |              |
|--|--------------|
| Stockholders' Equity:  |              |
| 7.875% Series A Cumulative Redeemable Preferred Stock:   |              |
| 7,412,500 shares authorized, issued and outstanding  | 177,088      |
| Common stock: par value \$.01 per share; 987,987,500 shares  |              |
| authorized, 538,546,666 and 401,822,703 issued and outstanding,  |              |
| respectively   | 5,385        |
| Additional paid-in capital   | 7,592,161    |
| Accumulated other comprehensive loss   | (478,791)    |
| Accumulated deficit  | (102,594)    |
|  | -----        |
| Total stockholders' equity   | 7,193,249    |
|  | -----        |
| Total liabilities, minority interest, Series B Cumulative Convertible Preferred Stock and stockholders' equity | \$61,484,135 |
|  | =====        |

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

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)  
(UNAUDITED)  
(dollars in thousands, except per share amounts)

|   | For the<br>Quarter Ended<br>June 30, 2008 | For the<br>Quarter Ended<br>June 30, 2007 | F<br>M<br>J |
|---|---|---|-------------|
| Interest income   | \$ 773,359                                | \$ 556,262                                | \$          |
| Interest expense  | 442,251                                   | 468,748                                   |             |
| Net interest income                                       | 331,108                                   | 87,514                                    |             |
| Other income:   |   |   |             |
| Investment advisory and service fees                      | 6,406                                     | 5,366                                     |             |
| Gain on sale of Investment Securities                     | 2,830                                     | 7,293                                     |             |
| Gain on termination of interest rate swaps                | --  | --  |             |
| Income from trading securities                            | 2,180                                     | 243                                       |             |
| Dividend income from available-for-sale equity securities | 580                                       | --  |             |
| Loss on other-than-temporarily impaired securities        | --  | (698)                                     |             |
| Total other income  | 11,996                                    | 12,204                                    |             |

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|  |             |              |    |
|--|-------------|--------------|----|
| Expenses:  |             |              |    |
| Distribution fees  | 370         | 861          |    |
| General and administrative expenses                              | 27,215      | 12,272       |    |
|  | -----       |              |    |
| Total expenses   | 27,585      | 13,133       |    |
|  | -----       |              |    |
| Income before income taxes and minority interest                 | 315,519     | 86,585       |    |
| Income taxes   | 7,527       | 839          |    |
|  | -----       |              |    |
| Income before minority interest                                  | 307,992     | 85,746       |    |
| Minority interest  | --          | 13           |    |
|  | -----       |              |    |
| Net income   | 307,992     | 85,733       |    |
| Dividends on preferred stock                                     | 5,334       | 5,373        |    |
|  | -----       |              |    |
| Net income available to common shareholders                      | \$ 302,658  | \$ 80,360    | \$ |
|  | =====       |              |    |
| Net income available per share to common shareholders:           |             |              |    |
| Basic  | \$ 0.60     | \$ 0.30      | \$ |
|  | =====       |              |    |
| Diluted  | \$ 0.59     | \$ 0.30      | \$ |
|  | =====       |              |    |
| Weighted average number of common shares outstanding:            |             |              |    |
| Basic  | 503,758,079 | 264,990,422  |    |
|  | =====       |              |    |
| Diluted  | 512,678,975 | 273,578,836  |    |
|  | =====       |              |    |
| Net income   | \$ 307,992  | \$ 85,733    | \$ |
|  | -----       |              |    |
| Other comprehensive loss:  |             |              |    |
| Unrealized gain on available-for-sale securities                 | (529,008)   | (535,413)    |    |
| Unrealized loss (gain) on interest rate swaps                    | 388,861     | 134,408      |    |
| Reclassification adjustment for net gains included in net income | (2,830)     | (6,595)      |    |
|  | -----       |              |    |
| Other comprehensive loss   | (142,977)   | (407,600)    |    |
|  | -----       |              |    |
| Comprehensive income (loss)                                      | \$ 165,015  | (\$ 321,867) | \$ |
|  | =====       |              |    |
| See notes to consolidated financial statements.                  |             |              |    |

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FOR THE QUARTERS ENDED MARCH 31 AND JUNE 30, 2008

(UNAUDITED)

(dollars in thousands, except per share data)

|   | Preferred<br>Stock | Common<br>Stock<br>Par Value | Additional<br>Paid-In<br>Capital | Other<br>Accu-<br>mulat-<br>Comp-<br>rehens-<br>Loss |
|---|--------------------|------------------------------|----------------------------------|--|
|   | -----              | -----                        | -----                            | -----  |
| BALANCE JANUARY 1, 2008   | \$ 177,088         | \$ 4,018                     | \$ 5,297,922                     | (\$ 152)   |
| Net income  | --                 | --                           | --                               |  |
| Other comprehensive loss  | --                 | --                           | --                               | (183)  |
| Exercise of stock options   | --                 | 2                            | 1,633                            |  |
| Stock option expense  | --                 | --                           | 322                              |  |
| Net proceeds from direct purchase and<br>dividend reinvestment                                | --                 | 33                           | 54,524                           |  |
| Net proceeds from follow-on offerings   | --                 | 587                          | 1,080,244                        |  |
| Net proceeds from ATM programs  | --                 | 44                           | 71,788                           |  |
| Conversion of Series B Cumulative<br>Convertible Preferred Stock                              | --                 | --                           | 61                               |  |
| Series A Cumulative Redeemable Preferred<br>Stock dividends declared, \$0.492188<br>per share | --                 | --                           | --                               |  |
| Series B Cumulative Convertible Preferred<br>Stock dividends declared, \$0.375 per<br>share   | --                 | --                           | --                               |  |
| Common dividends declared, \$0.48 per share   | --                 | --                           | --                               |  |
|   | -----              | -----                        | -----                            | -----  |
| BALANCE, MARCH 31, 2008   | 177,088            | 4,684                        | 6,506,494                        | (335)  |
| Net income  | --                 | --                           | --                               |  |
| Other comprehensive loss  | --                 | --                           | --                               | (142)  |
| Exercise of stock options   | --                 | --                           | 195                              |  |
| Stock option expense  | --                 | --                           | 517                              |  |
| Net proceeds from direct purchase and<br>dividend reinvestment                                | --                 | 9                            | 16,481                           |  |
| Net proceeds from follow-on offerings   | --                 | 690                          | 1,066,028                        |  |
| Conversion of Series B Cumulative<br>Convertible Preferred Stock                              | --                 | 2                            | 2,446                            |  |
| Series A Cumulative Redeemable Preferred<br>Stock dividends declared, \$0.492188<br>per share | --                 | --                           | --                               |  |
| Series B Cumulative Convertible Preferred<br>Stock dividends declared, \$0.375 per share      | --                 | --                           | --                               |  |
| Common dividends declared, \$0.55 per share   | --                 | --                           | --                               |  |
|   | -----              | -----                        | -----                            | -----  |
| BALANCE, JUNE 30, 2008  | \$ 177,088         | \$ 5,385                     | \$ 7,592,161                     | (\$ 478)   |
|   | =====              | =====                        | =====                            | =====  |

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (UNAUDITED)  
 (dollars in thousands)

|  | For the<br>Quarter Ended<br>June<br>30, 2008 | For the<br>Quarter Ended<br>June<br>30, 2007 |
|--|--|--|
|  | -----  | -----  |
| Cash flows from operating activities:  |  |  |
| Net income   | \$ 307,992                                   | \$ 85,733                                    |
| Adjustments to reconcile net income to net cash provided<br>by operating activities: |  |  |
| Amortization of Mortgage Backed Securities premiums<br>and discounts, net            | 26,613                                       | 16,737                                       |
| Amortization of intangibles  | 1,236  | 349  |
| Amortization of trading securities premiums and discounts                            | --   | (3)  |
| Gain on sale of Investment Securities  | (2,830)                                      | (7,293)                                      |
| Gain on termination of interest rate swaps   | --   | --   |
| Stock option and long-term compensation expense                                      | 517  | 362  |
| Net realized gain on trading investments   | (1,837)                                      | (346)  |
| Unrealized depreciation (appreciation) on trading investments                        | 351  | 813  |
| Loss on other-than-temporarily impaired securities                                   | --   | 698  |
| Increase in accrued interest receivable  | (17,040)                                     | (17,900)                                     |
| Decrease (increase) in other assets  | 1,131  | (22)   |
| Purchase of trading securities   | (11,270)                                     | (9,697)                                      |
| Proceeds from sale of trading securities   | --   | 4,592  |
| Purchase from trading securities sold, not yet purchased                             | (1,987)                                      | (3,951)                                      |
| Proceeds for securities sold, not yet purchased                                      | 4,551  | 2,388  |
| Decrease in trading sales receivable   | --   | --   |
| (Increase) decrease in advisory and service fees receivable                          | (123)  | (5)  |
| Increase (decrease) in interest payable  | (17,960)                                     | 25,094                                       |
| Increase (decrease) in accrued expenses and other liabilities                        | 16,501                                       | 6,578  |
|  | -----  | -----  |
| Net cash provided by operating activities  | 305,845                                      | 104,127                                      |
| Cash flows from investing activities:  |  |  |
| Purchase of Mortgage-Backed Securities   | (6,802,127)                                  | (5,303,629)                                  |
| Proceeds from sale of Investment Securities  | 1,497,894                                    | 1,458,787                                    |
| Principal payments of Mortgage-Backed Securities                                     | 2,793,143                                    | 1,952,728                                    |
| Purchase of agency debentures  | --   | --   |
| Proceeds from termination of swaps   | --   | --   |
| Purchase of reverse repurchase agreements  | 750,036                                      | --   |
|  | -----  | -----  |
| Net cash used in investing activities  | (1,761,054)                                  | (1,892,114)                                  |
| Cash flows from financing activities:  |  |  |
| Proceeds from repurchase agreements  | 108,736,743                                  | 103,964,854                                  |
| Principal payments on repurchase agreements  | (108,221,087)                                | (102,219,009)                                |
| Proceeds from exercise of stock options  | 195  | 64   |
| Proceeds from direct purchase and dividend reinvestment                              | 16,490                                       | 29,456                                       |

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|   |              |              |
|---|--------------|--------------|
| Net proceeds from follow-on offerings   | 1,066,718    | (178)        |
| Net proceeds from ATM programs  | --           | 65,908       |
| Minority interest   | --           | 13           |
| Dividends paid  | (230,154)    | (57,950)     |
|   | -----        | -----        |
| Net cash provided by financing activities   | 1,368,905    | 1,783,158    |
|   | -----        | -----        |
| Net (decrease) increase in cash and cash equivalents  | (86,304)     | (4,829)      |
| Cash and cash equivalents, beginning of period  | 1,549,041    | 96,610       |
|   | -----        | -----        |
| Cash and cash equivalents, end of period  | \$ 1,462,737 | \$ 91,781    |
|   | =====        | =====        |
| Supplemental disclosure of cash flow information:   |              |              |
| Interest paid   | \$ 460,211   | \$ 443,654   |
|   | =====        | =====        |
| Taxes paid  | \$ 9,091     | \$ 2,105     |
|   | =====        | =====        |
| Noncash financing activities:   |              |              |
| Net change in unrealized loss on available-for-sale securities<br>and interest rate swaps, net of reclassification adjustment | (\$ 142,977) | (\$ 407,600) |
|   | =====        | =====        |
| Dividends declared, not yet paid  | \$ 296,201   | \$ 64,652    |
|   | =====        | =====        |

See notes to consolidated financial statements.

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ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE QUATER ENDED JUNE 30, 2008 AND 2007

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Capital Management, Inc. ("Annaly" or the "Company") was incorporated in Maryland on November 25, 1996. The Company commenced its operations of purchasing and managing an investment portfolio of mortgage-backed securities on February 18, 1997, upon receipt of the net proceeds from the private placement of equity capital, and completed its initial public offering on October 14, 1997. The Company is a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended. Fixed Income Discount Advisory Company ("FIDAC") is a registered investment advisor and is a wholly owned taxable REIT subsidiary of the Company. On June 27, 2006, the Company made a majority equity investment in an affiliated investment fund (the "Fund"), which is now wholly owned by the Company. The Company acquired approximately 3.6 million shares of common stock of Chimera Investment Corporation ("Chimera") for approximately \$54.3 million on November 21, 2007. Chimera is a newly-formed, publicly traded, specialty finance company that invests in residential mortgage loans, residential mortgage-backed securities, real estate related securities and various other asset classes. Chimera is externally managed by FIDAC and intends to elect and qualify to be taxed as a REIT for federal income tax purposes.



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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 do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America ("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 statement of the financial positions, results of operations, and cash flows have been included. 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.

The consolidated financial statements include the accounts of the Company, FIDAC and the Fund. All intercompany balances and transactions have been eliminated. The minority shareholder's interest in the Fund is reflected as minority interest in the consolidated financial statements.

**Cash and Cash Equivalents** - Cash and cash equivalents include cash on hand and cash held in money market funds overnight.

**Reverse Repurchase Agreements** - The Company may invest its daily available cash balances via reverse repurchase agreements to provide additional yield on its assets. These investments will typically be recorded as short term investments and will mature daily. Reverse repurchase agreements are recorded at cost and are collateralized by mortgage-backed securities pledged by the counterparty to the agreement.

**Mortgage-Backed Securities and Agency Debentures** - The Company invests primarily in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans, and in certificates guaranteed by the Government National Mortgage Association ("GNMA") (collectively, "Mortgage-Backed Securities"). The Company also invests in agency debentures issued by Federal Home Loan Bank ("FHLB"), Federal Home Loan Mortgage Corporation ("FHLMC"), and Federal National Mortgage Association ("FNMA"). The Mortgage-Backed Securities and agency debentures are collectively referred to herein as "Investment Securities."

**Statement of Financial Accounting Standards ("SFAS") No. 115, Accounting for Certain Investments in Debt and Equity Securities ("SFAS 115")**, 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 Investment Securities until maturity, it may, from time to time, sell any of its Investment Securities as part of its overall management of its portfolio. Accordingly, SFAS 115 requires the Company to classify all of its Investment Securities as available-for-sale. All assets classified as available-for-sale are reported at estimated fair value, based on market prices from independent sources, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity. The Company's investment in Chimera is accounted for as available-for-sale equity securities under the provisions of SFAS 115.

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Management evaluates 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, and (3) the intent and ability of the Company to retain its investment in the issuer 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 other-than-temporary factors, are recognized in income and the cost basis of the Investment Securities is adjusted. For the quarter and six months ended June 30, 2008, there was no loss on other-than-temporarily impaired securities. For the quarter and six months ended June 30, 2007, the loss on other-than-temporarily impaired securities was \$698,00 and \$1.2 million, respectively.

SFAS No. 107, Disclosure About Fair Value of Financial Instruments, requires disclosure of the fair value of financial instruments for which it is practicable to estimate that value. The estimated fair value of Investment Securities, available-for-sale equity securities and interest rate swaps is equal to their carrying value presented in the consolidated statements of financial condition. The estimated fair value of trading securities and trading securities sold, not yet purchased, is equal to their carrying value presented in the consolidated statements of financial condition. The estimated fair value of cash and cash equivalents, accrued interest receivable, receivable for securities sold, receivable for advisory and service fees, repurchase agreements with maturities shorter than one year, payable for mortgage-backed securities purchased, dividends payable, accounts payable, and accrued interest payable, generally approximates cost as of June 30, 2008 due to the short term nature of these financial instruments.

Interest income is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized into interest income over the projected lives of the securities using the interest method. The Company's policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, consensus prepayment speeds, and current market conditions. Dividend income on available-for-sale equity securities is recorded on the ex-date on an accrual basis.

Investment Securities transactions are recorded on the trade date. Purchases of newly-issued securities are recorded when all significant uncertainties regarding the characteristics of the securities are removed, generally shortly before settlement date. Realized gains and losses on sales of Investment Securities are determined on the specific identification method.

Derivative Financial Instruments/Hedging Activity - The Company hedges interest rate risk through the use of derivative financial instruments comprised of interest rate caps and interest rate swaps (collectively, "Hedging Instruments"). The Company accounts for Hedging Instruments in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133"), as amended and interpreted. The Company carries all Hedging Instruments at their fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative. As the Company's interest rate swaps are designated as cash flow hedges under SFAS 133, the change in the fair value of any such derivative is recorded in other comprehensive income or loss for hedges that qualify as effective. At June 30, 2008, the Company did not have any interest rate caps. The ineffective amount of all Hedging Instruments, if any, is recognized in earnings each quarter. To date, the Company has not recognized any change in the value of its interest rate swaps in earnings as a result of a hedge or a portion thereof being ineffective.

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Upon entering into hedging transactions, the Company documents the relationship between the Hedging Instruments and the hedged liability. The Company also documents its risk-management policies, including objectives and strategies, as they relate to its hedging activities. The Company assesses, both at inception of a hedge and on an on-going basis, whether or not the hedge is "highly effective," as defined by SFAS 133. The Company discontinues hedge accounting on a prospective basis with changes in the estimated fair value reflected in earnings when (i) it is determined that the derivative is no longer effective in offsetting cash flows of a hedged item (including hedged items such as forecasted transactions); (ii) it is no longer probable that the forecasted transaction will occur; or (iii) it is determined that designating the derivative as a Hedging Instrument is no longer appropriate.

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When the Company enters into an interest rate swap, it agrees to pay a fixed rate of interest and to receive a variable interest rate, generally based on the London Interbank Offered Rate ("LIBOR"). The Company's interest rate swaps are designated as cash flow hedges against the benchmark interest rate risk associated with the Company's borrowings.

If it becomes probable that the forecasted transaction, which in this case refers to interest payments to be made under the Company's short-term borrowing agreements, will not occur by the end of the originally specified time period, as documented at the inception of the hedging relationship, the related gain or loss in accumulated other comprehensive income or loss would be reclassified to income or loss.

Realized gains and losses resulting from the termination of an interest rate swap are initially recorded in accumulated other comprehensive income or loss as a separate component of stockholders' equity. The gain or loss from a terminated interest rate swap remains in accumulated other comprehensive income or loss until the forecasted interest payments affect earnings. If it becomes probable that the forecasted interest payments will not occur, the entire gain or loss would be recognized in earnings.

Credit Risk - The Company has limited its exposure to credit losses on its portfolio of Investment Securities by only purchasing securities issued by FHLMC, FNMA, or GNMA and agency debentures issued by the FHLB, FHLMC and FNMA. The payment of principal and interest on the FHLMC and FNMA Mortgage-Backed Securities are guaranteed by those respective agencies, and the payment of principal and interest on the GNMA Mortgage-Backed Securities are backed by the full faith and credit of the U.S. government. Principal and interest on agency debentures are guaranteed by the agency issuing the debenture. All of the Company's Investment Securities have an actual or implied "AAA" rating. The Company faces credit risk on the portions of its portfolio which are not Investment Securities.

Market Risk - The current situation in the sub-prime 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, and 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. Even with the current situation in the sub-prime

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mortgage sector, the Company does not anticipate having difficulty converting its assets to cash or extending financing terms due to the fact that its Investment Securities have an actual or implied "AAA" rating and principal payment is guaranteed by FHLMC, FNMA, or GNMA.

Trading Securities and Trading Securities sold, not yet purchased - Trading securities and trading securities sold, not yet purchased, are presented in the consolidated statements of financial conditions as a result of consolidating the financial statements of the Fund, and are carried at fair value. The realized and unrealized gains and losses, as well as other income or loss from trading securities, are recorded in the income from trading securities balance in the accompanying consolidated statements of operations.

Trading securities sold, not yet purchased, represent obligations of the Fund to deliver the specified security at the contracted price, and thereby create a liability to purchase the security in the market at prevailing prices.

Repurchase Agreements - The Company finances the acquisition of its Investment Securities through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

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Cumulative Convertible Preferred Stock- The Company classifies its Series B Cumulative Convertible Preferred Stock ("Series B Preferred Stock") on the consolidated statements of financial condition using the guidance in SEC Accounting Series Release No. 268, Presentation in Financial Statements of "Redeemable Preferred Stocks," and Emerging Issues Task Force ("EITF") Topic D-98, Classification and Measurement of Redeemable Securities. The Series B Preferred Stock contains fundamental change provisions that allow the holder to redeem the Series B Preferred Stock for cash if certain events occur. As redemption under these provisions is not solely within the Company's control, the Company has classified the Series B Preferred Stock as temporary equity in the accompanying consolidated statements of financial condition.

The Company has analyzed whether the embedded conversion option should be bifurcated under the guidance in SFAS 133 and EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, and has determined that bifurcation is not necessary.

Income Taxes - The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and FIDAC have made a joint election to treat FIDAC as a taxable REIT subsidiary. As such, FIDAC is taxable as a domestic C corporation and subject to federal and state and local income taxes based upon its taxable income.

Use of Estimates - The preparation of the consolidated 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.

Goodwill and Intangible assets - The Company's acquisition of FIDAC was

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accounted for using the purchase method. Under the purchase method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. In addition, the cost of FIDAC was allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of purchase price over the fair value of the net assets acquired was recognized as goodwill. Intangible assets are periodically (but not less frequently than annually) reviewed for potential impairment. Intangible assets with an estimated useful life are expected to amortize over a 6.4 year weighted average time period. During the quarters and six months ended June 30, 2008 and 2007, there were no impairment losses on goodwill and intangible assets.

Stock Based Compensation - The Company accounts for its stock-based compensation in accordance with SFAS No. 123 (Revised 2004) - Share-Based Payment ("SFAS 123R"). SFAS 123R requires the Company to measure and recognize in the consolidated financial statements the compensation cost relating to share-based payment transactions. The compensation cost should be reassessed based on the fair value of the equity instruments issued.

The Company recognizes compensation expense on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). The Company estimated fair value using the Black-Scholes valuation model.

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 their financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined). Additionally, companies are required to provide enhanced disclosure regarding instruments in the level 3 category (the valuation of which require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. SFAS 157 was adopted by the Company on January 1, 2008. SFAS 157 did not have an impact on the manner in which the Company estimates fair value, but it requires additional disclosure, which is included in Note 5.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - including an amendment of FASB Statement No. 115 ("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 was effective for the Company commencing January 1, 2008. The Company did not elect the fair value option for any of its financial instruments.

In April 2007, the FASB issued a FASB Staff Position FIN 39-1 ("FSP FIN 39-1") which modifies FASB Interpretation No. 39, Offsetting of Amounts relating to Certain Contracts ("FIN 39"). FSP FIN 39-1 addresses whether a reporting entity that is party to a master netting arrangement can offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with FIN 39. Upon adoption of this guidance, a reporting entity is permitted to change its accounting policy to offset or not offset fair value amounts recognized for derivative instruments

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under master netting arrangements. This guidance was effective for the Company on January 1, 2008. The implementation did not have an effect on the financial statements of the Company.

In February 2008, FASB issued FASB Staff Position No. FAS 140-3 Accounting for Transfers of Financial Assets and Repurchase Financing Transactions, ("FSP FAS 140-3"). FSP FAS 140-3 addresses whether transactions where assets purchased from a particular counterparty and financed through a repurchase agreement with the same counterparty can be considered and accounted for as separate transactions, or are required to be considered "linked" transactions and may be considered derivatives under SFAS 133. FSP FAS 140-3 requires purchases and subsequent financing through repurchase agreements be considered linked transactions unless all of the following conditions apply: (1) the initial purchase and the use of repurchase agreements to finance the purchase are not contractually contingent upon each other; (2) the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed; (3) the financial assets are readily obtainable in the market; and (4) the financial instrument and the repurchase agreement are not coterminous. This FSP is effective for the Company on January 1, 2009. The Company is currently evaluating FSP FAS 140-3 but does not expect its application to have a significant impact on its financial reporting.

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

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### 2. MORTGAGE-BACKED SECURITIES

The following tables present the Company's available-for-sale Mortgage-Backed Securities portfolio as of June 30, 2008 and December 31, 2007, which were carried at their fair value:

|                        | Federal Home Loan<br>Mortgage<br>Corporation | Federal National<br>Mortgage<br>Association | Government<br>National Mortgage<br>Association | Tota<br>Backe |
|------------------------|--|---|--|---------------|
| June 30, 2008          |  |   |  |               |
| -----                  |  |   |  |               |
| (dollars in thousands) |  |   |  |               |

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Mortgage-Backed

|                         |    |            |    |            |    |         |    |
|-------------------------|----|------------|----|------------|----|---------|----|
| Securities, gross       | \$ | 21,744,712 | \$ | 35,454,105 | \$ | 348,861 | \$ |
| Unamortized discount    |    | (28,693)   |    | (42,005)   |    | (1,164) |    |
| Unamortized premium     |    | 209,209    |    | 361,951    |    | 2,162   |    |
| -----                   |    |            |    |            |    |         |    |
| Amortized cost          |    | 21,925,228 |    | 35,774,051 |    | 349,859 |    |
| Gross unrealized gains  |    | 129,339    |    | 193,718    |    | 1,554   |    |
| Gross unrealized losses |    | (125,118)  |    | (229,059)  |    | (2,267) |    |
| -----                   |    |            |    |            |    |         |    |

|                      |    |            |    |            |    |         |    |
|----------------------|----|------------|----|------------|----|---------|----|
| Estimated fair value | \$ | 21,929,449 | \$ | 35,738,710 | \$ | 349,146 | \$ |
| =====                |    |            |    |            |    |         |    |

|       |                |                       |                       |       |
|-------|----------------|-----------------------|-----------------------|-------|
|       | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Estim |
| ----- |                |                       |                       |       |

(dollars in thousands)

|                 |    |            |    |         |     |           |    |
|-----------------|----|------------|----|---------|-----|-----------|----|
| Adjustable rate | \$ | 18,333,869 | \$ | 130,357 | (\$ | 140,838)  | \$ |
| Fixed rate      |    | 39,715,269 |    | 194,254 |     | (215,606) |    |
| -----           |    |            |    |         |     |           |    |

|       |    |            |    |         |     |          |    |
|-------|----|------------|----|---------|-----|----------|----|
| Total | \$ | 58,049,138 | \$ | 324,611 | (\$ | 356,444) | \$ |
| ===== |    |            |    |         |     |          |    |

|                   |  |   |  |       |
|-------------------|--|---|--|-------|
|                   | Federal Home Loan<br>Mortgage<br>Corporation | Federal National<br>Mortgage<br>Association | Government<br>National Mortgage<br>Association | Tota  |
| December 31, 2007 |  |   |  | Backe |
| -----             |  |   |  |       |

(dollars in thousands)

|                         |    |            |    |            |    |         |    |
|-------------------------|----|------------|----|------------|----|---------|----|
| Mortgage-Backed         |    |            |    |            |    |         |    |
| Securities, gross       | \$ | 19,789,792 | \$ | 32,155,740 | \$ | 367,066 | \$ |
| Unamortized discount    |    | (30,679)   |    | (45,496)   |    | (506)   |    |
| Unamortized premium     |    | 136,780    |    | 266,357    |    | 2,678   |    |
| -----                   |    |            |    |            |    |         |    |
| Amortized cost          |    | 19,895,893 |    | 32,376,601 |    | 369,238 |    |
| Gross unrealized gains  |    | 141,248    |    | 224,795    |    | 2,229   |    |
| Gross unrealized losses |    | (52,623)   |    | (75,949)   |    | (1,904) |    |
| -----                   |    |            |    |            |    |         |    |

|                      |    |            |    |            |    |         |    |
|----------------------|----|------------|----|------------|----|---------|----|
| Estimated fair value | \$ | 19,984,518 | \$ | 32,525,447 | \$ | 369,563 | \$ |
| =====                |    |            |    |            |    |         |    |

|       |                |                       |                       |       |
|-------|----------------|-----------------------|-----------------------|-------|
|       | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Estim |
| ----- |                |                       |                       |       |

(dollars in thousands)

|                 |    |            |    |         |     |          |    |
|-----------------|----|------------|----|---------|-----|----------|----|
| Adjustable rate | \$ | 15,361,031 | \$ | 96,310  | (\$ | 76,853)  | \$ |
| Fixed rate      |    | 37,280,701 |    | 271,962 |     | (53,623) |    |
| -----           |    |            |    |         |     |          |    |

|       |    |            |    |         |     |          |    |
|-------|----|------------|----|---------|-----|----------|----|
| Total | \$ | 52,641,732 | \$ | 368,272 | (\$ | 130,476) | \$ |
| ===== |    |            |    |         |     |          |    |

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Actual maturities of Mortgage-Backed Securities are generally shorter than stated contractual maturities because actual maturities of Mortgage-Backed Securities 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 Mortgage-Backed Securities on June 30, 2008 and December 31, 2007, according to their estimated weighted-average life classifications:

| Weighted-Average Life                          | June 30, 2008       |  | December 31, 2007   |                     |
|--|---------------------|--|---------------------|---------------------|
|  | Fair Value          | Amortized Cost<br>(dollars in thousands) | Fair Value          | Amortized Cost      |
| Less than one year                             | \$ 318,991          | \$ 324,216                               | \$ 324,495          | \$ 324,495          |
| Greater than one year and less than five years | 30,640,030          | 30,606,547                               | 35,772,813          | 35,772,813          |
| Greater than or equal to five years            | 27,058,284          | 27,118,375                               | 16,782,220          | 16,782,220          |
| <b>Total</b>                                   | <b>\$58,017,305</b> | <b>\$58,049,138</b>                      | <b>\$52,879,528</b> | <b>\$52,879,528</b> |

The weighted-average lives of the Mortgage-Backed Securities at June 30, 2008 and December 31, 2007 in the table above are based upon data provided through subscription-based financial information services, assuming constant principal prepayment rates to the reset date of each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loans, loan age, margin and volatility.

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 June 30, 2008.

| 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 |
| (dollars in thousands)        |                   |                      |                   |                      |
| \$24,295,525                  | (\$284,431)       | \$3,268,428          | (\$72,013)        | \$27,563,953         |

The decline in value of these securities is solely due to market conditions and not the quality of the assets. All of the Mortgage-Backed Securities are "AAA" rated or carry an implied "AAA" rating. The investments are not considered other-than-temporarily impaired because the Company currently has the ability and intent to hold the investments to maturity or for a period of



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time sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Also, the Company is guaranteed payment of the principal amount of the securities by the government agency which created them.

The adjustable rate Mortgage-Backed Securities are limited by periodic caps (generally interest rate adjustments are limited to no more than 1% every nine months) and lifetime caps. The weighted average lifetime cap was 9.9% at June 30, 2008 and December 31, 2007.

During the quarter and six months ended June 30, 2008, the Company realized \$2.8 million and \$12.2 million in net gains from sales of Investment Securities. During the quarter and six months ended June 30, 2007, the Company realized \$7.3 million and \$13.4 million in net gains from sales of Investment Securities, respectively.

### 3. AVAILABLE FOR SALE EQUITY SECURITIES

All of the equity securities are shares of Chimera. The Company purchased shares of Chimera for \$54.3 million and they had a fair value of \$32.6 million at June 30, 2008.

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The Company evaluated the near-term prospects of Chimera in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold this investment for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2008.

### 4. REVERSE REPURCHASE AGREEMENT

At June 30, 2008, the Company had lent \$50.0 million in an overnight reverse repurchase agreement. The interest rate at June 30, 2008 was 3.96%. The collateral for this loan is non-Agency mortgage-backed securities.

### 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:

Level 1- inputs to the valuation methodology are quoted prices (unadjusted) for identical assets and liabilities in active markets.

Level 2 - inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

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

Available for sale equity securities, trading securities, and trading securities sold, not yet purchased are valued based on quoted prices (unadjusted) in an active market. Investment Securities and interest rate swaps are valued using quoted prices for similar assets and dealer quotes. The dealer

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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 and expected life of the security. Management reviews all prices used to ensure that current market conditions are represented. This review includes comparisons of similar market transactions and comparisons to a pricing model. The Company's financial assets and liabilities carried at fair value on a recurring basis are valued as follows:

|  | Level 1                | Level 2      | Level 3 |
|--|------------------------|--------------|---------|
|  | (dollars in thousands) |              |         |
| -----                                      |                        |              |         |
| <b>Assets:</b>                             |                        |              |         |
| Mortgage-Backed Securities                 | --                     | \$58,017,305 | --      |
| Agency debentures                          | --                     | 731,995      | --      |
| Available for sale equity securities       | \$ 32,631              | --           | --      |
| Trading securities                         | 23,478                 | --           | --      |
| <b>Liabilities:</b>                        |                        |              |         |
| Trading securities sold, not yet purchased | 48,718                 | --           | --      |
| Interest rate swaps                        | --                     | 400,998      | --      |

### 6. REPURCHASE AGREEMENTS

The Company had outstanding \$51.8 billion and \$46.0 billion of repurchase agreements with weighted average borrowing rates of 3.40% and 4.76%, after giving effect to the Company's interest rate swaps, and weighted average remaining maturities of 224 days and 234 days as of June 30, 2008 and December 31, 2007, respectively. Investment Securities pledged as collateral under these repurchase agreements and interest rate swaps had an estimated fair value of \$55.6 billion at June 30, 2008 and \$48.3 billion at December 31, 2007.

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At June 30, 2008 and December 31, 2007, the repurchase agreements had the following remaining maturities:

|                | June 30, 2008          | December 31, 2007 |
|----------------|------------------------|-------------------|
|                | (dollars in thousands) |                   |
| -----          |                        |                   |
| Within 30 days | \$39,995,989           | \$34,940,600      |
| 30 to 59 days  | 4,107,944              | 4,005,960         |
| 60 to 89 days  | 85,730                 | 300,000           |
| 90 to 119 days | --                     | --                |
| Over 120 days  | 7,650,000              | 6,800,000         |
| -----          |                        |                   |
| Total          | \$51,839,663           | \$46,046,560      |
| =====          |                        |                   |

The Company did not have an amount at risk greater than 10% of the equity of the Company with any counterparty as of June 30, 2008 or December 31, 2007.

The Company has entered into repurchase agreements which provide the

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counterparty with the right to call the balance prior to maturity date. These repurchase agreements totaled \$7.7 billion and the fair value of the option to call was (\$199.5 million) at June 30, 2008. The repurchase agreements totaled \$6.4 billion and the market value of the option to call was (\$176.7 million) at December 31, 2007. Management has determined that the call option is not required to be bifurcated under the provisions of SFAS 133 as it is deemed clearly and closely related to the debt instrument, therefore the option value is not recorded in the consolidated financial statements.

### 7. INTEREST RATE SWAPS

In connection with the Company's interest rate risk management strategy, the Company hedges a portion of its interest rate risk by entering into derivative financial instrument contracts. As of June 30, 2008, such instruments are comprised of interest rate swaps, which in effect modify the cash flows on repurchase agreements. The use of interest rate swaps creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. In the event of a default by the counterparty, the Company could have difficulty obtaining its Mortgage-Backed Securities pledged as collateral for swaps. The Company does not anticipate any defaults by its counterparties.

The Company's swaps are used to lock-in the fixed rate related to a portion of its current and anticipated future 30-day term repurchase agreements.

The table below presents information about the Company's swaps outstanding at June 30, 2008 and December 31, 2007.

|                   | Notional Amount<br>(dollars in thousands) | Weighted Average<br>Pay Rate | Weighted Average<br>Receive Rate | Net Esti<br>Value/Ca<br>(dollars |
|-------------------|---|------------------------------|----------------------------------|----------------------------------|
| June 30, 2008     | \$17,689,150                              | 4.78%                        | 2.47%                            | (\$                              |
| December 31, 2007 | \$16,243,500                              | 5.03%                        | 5.06%                            | (\$                              |

### 8. PREFERRED STOCK AND COMMON STOCK

#### (A) Common Stock Issuances

On May 13, 2008 the Company entered into an underwriting agreement pursuant to which it sold 69,000,000 shares of its common stock for net proceeds following underwriting expenses of approximately \$1.1 billion. This transaction settled on May 19, 2008.

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On January 23, 2008 the Company entered into an underwriting agreement pursuant to which it sold 58,650,000 shares of its common stock for net proceeds following underwriting expenses of approximately \$1.1 billion. This transaction settled on January 29, 2008.

During the quarter and six months ended June 30, 2008, the Company

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raised \$16.5 million and \$71.1 million by issuing 957,091 and 4.3 million shares, respectively, through the Direct Purchase and Dividend Reinvestment Program.

During the quarter and six months ended June 30, 2008, 16,600 and 187,217 options were exercised under the Long-Term Stock Incentive Plan, or Incentive Plan, for an aggregate exercise price of \$195,000 and \$1.8 million, respectively.

On August 3, 2006, the Company entered into an ATM Equity Offering(sm) Sales Agreement with Merrill Lynch & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, relating to the sale of shares of its common stock from time to time through Merrill Lynch. Sales of the shares, if any, are made by means of ordinary brokers' transaction on the New York Stock Exchange. During the six months ended June 30, 2008, 588,000 shares of the Company's common stock were issued pursuant to this program, totaling \$11.5 million in net proceeds. On August 3, 2006, the Company entered into an ATM Equity Sales Agreement with UBS Securities LLC, relating to the sale of shares of its common stock from time to time through UBS Securities. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the six months ended June 30, 2008, 3.8 million shares of the Company's common stock were issued pursuant to this program, totaling \$60.3 million in net proceeds. During the quarter ended June 30, 2008, the Company did not issue stock under either of these ATM programs.

### (B) Preferred Stock

At June 30, 2008, the Company had issued and outstanding 7,412,500 shares of Series A Cumulative Redeemable Preferred Stock ("Series A Preferred Stock"), with a par value \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series A Preferred Stock must be paid a dividend at a rate of 7.875% per year on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on April 5, 2009 (subject to the Company's right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve its qualification as a REIT). The Series A Preferred Stock is senior to the Company's common stock and is on parity with the Series B Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series A Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series A Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series A Preferred Stock, together with the Series B Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set apart for payment. In addition, certain material and adverse changes to the terms of the Series A Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series A Preferred Stock and Series B Preferred Stock. Through June 30, 2008, the Company had declared and paid all required quarterly dividends on the Series A Preferred Stock.

At June 30, 2008, the Company had issued and outstanding 4,496,525 shares of Series B Preferred Stock, with a par value \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series B Preferred Stock must be paid a dividend at a rate of 6% per year on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends.

The Series B Preferred Stock is not redeemable. The Series B Preferred Stock is convertible into shares of common stock at a conversion rate that

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adjusts from time to time upon the occurrence of certain events, including if the Company distributes to its common shareholders in any calendar quarter cash dividends in excess of \$0.11 per share. Initially, the conversion rate was 1.7730 shares of common shares per \$25 liquidation preference. At June 30, 2008, the conversion ratio was 1.9554 shares of common stock per \$25 liquidation preference. Commencing April 5, 2011, the Company has the right in certain circumstances to convert each Series B Preferred Stock into a number of common shares based upon the then prevailing conversion rate. The Series B Preferred Stock is also convertible into common shares at the option of the Series B preferred shareholder at anytime at the then prevailing conversion rate. The Series B Preferred Stock is senior to the Company's common stock and is on parity with the Series A Preferred Stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series B Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series B Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series B Preferred Stock, together with the Series A Preferred Stock, will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set apart for payment. In addition, certain material and adverse changes to the terms of the Series B Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series B Preferred Stock and Series A Preferred Stock. Through June 30, 2008, the Company had declared and paid all required quarterly dividends on the Series B Preferred Stock. During the quarter ended June 30, 2008, 101,025 shares of Series B Preferred Stock were converted into 192,151 shares of common stock.

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### (C) Distributions to Shareholders

During the quarter ended June 30, 2008, the Company declared dividends to common shareholders totaling \$296.2 million or \$0.55 per share, which were paid to shareholders on July 29, 2008. During the quarter ended June 30, 2008, the Company declared dividends to Series A Preferred shareholders totaling approximately \$3.6 million or \$0.492188 per share, and Series B shareholders totaling approximately \$1.7 million or \$0.375 per share, which were paid to shareholders on June 30, 2008.

### 9. NET INCOME PER COMMON SHARE

The following table presents a reconciliation of the net income and shares used in calculating basic and diluted earnings per share for the quarters and six months ended June 30, 2008 and 2007.

|                                 | For the Quarters Ended<br>June 30, |           | For the Six Months<br>June 30 |    |
|---------------------------------|------------------------------------|-----------|-------------------------------|----|
|                                 | 2008                               | 2007      | 2008                          |    |
|                                 | (dollars in thousands)             |           |                               |    |
|                                 |                                    |           |                               |    |
| Net income                      | \$ 307,992                         | \$ 85,733 | \$ 551,028                    | \$ |
| Less: Preferred stock dividends | 5,334                              | 5,373     | 10,707                        |    |
|                                 |                                    |           |                               |    |

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|   |            |           |            |    |
|---|------------|-----------|------------|----|
| Net income available to common shareholders,<br>prior to adjustment for Series B dividends, if<br>necessary | \$ 302,658 | \$ 80,360 | \$ 540,321 | \$ |
| Add: Preferred Series B dividends, if Series B<br>shares are dilutive                                       | 1,685      | 1,725     | 3,410      |    |
| Net income, as adjusted   | \$ 304,343 | \$ 82,085 | \$ 543,731 | \$ |
| Weighted average shares of common stock<br>outstanding-basic  | 503,758    | 264,990   | 473,785    |    |
| Add: Effect of dilutive stock options and   | 128        | 228       | 235        |    |
| Series B Cumulative Convertible Preferred Stock   | 8,793      | 8,361     | 8,793      |    |
| Weighted average shares of common<br>stock outstanding-diluted  | 512,679    | 273,579   | 482,813    |    |

Options to purchase 1.8 million and 572,000 shares of common stock, respectively, were outstanding and considered anti-dilutive as their exercise price exceeded the average stock price for the quarter and six months ended June 30, 2008. Options to purchase 2,471,375 shares of common stock were outstanding and considered anti-dilutive as their exercise price exceeded the average stock price for the quarter and six months ended June 30, 2007.

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10. LONG-TERM STOCK INCENTIVE PLAN

The Company has adopted a long term stock incentive plan for executive officers, key employees and non-employee directors (the "Incentive Plan"). The Incentive Plan authorizes the Compensation Committee of the board of directors to grant awards, including non-qualified options as well as incentive stock options as defined under Section 422 of the Code. The Incentive Plan authorizes the granting of options or other awards for an aggregate of the greater of 500,000 shares or 9.5% of the diluted outstanding shares of the Company's common stock, up to ceiling of 8,932,921 shares. Stock options are issued at the current market price on the date of grant, subject to an immediate or four year vesting in four equal installments with a contractual term of 5 or 10 years. The grant date fair value is calculated using the Black-Scholes option valuation model.

|  | For the six months ended Ju<br>2008 |                                       |                    |
|--|-------------------------------------|---------------------------------------|--------------------|
|  | Number of<br>Shares                 | Weighted<br>Average<br>Exercise Price | Number o<br>Shares |
| Options outstanding at the beginning of period | 3,437,267                           | \$15.23                               | 2,98               |
| Granted  | 1,004,900                           | 16.45                                 | 68                 |

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|  |           |         |       |
|--|-----------|---------|-------|
| Exercised                                    | (187,217) | 9.77    | (47)  |
| Forfeited                                    | (2,550)   | 16.16   | (174) |
| Expired                                      | (5,000)   | 20.70   | (5)   |
|  |           |         |       |
| Options outstanding at the end of period     | 4,247,400 | \$15.76 | 3,44  |
|  |           |         |       |
| Options exercisable at the end of the period | 2,060,750 | \$15.92 | 1,29  |
|  |           |         |       |

The weighted average remaining contractual term was approximately 7.4 years for stock options outstanding and approximately 5.9 years for stock options exercisable as of June 30, 2008. The weighted average remaining contractual term was approximately 7.5 years for stock options outstanding and approximately 5.8 years for stock options exercisable as of June 30, 2007. As of June 30, 2008, there was approximately \$5.3 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 3.2 years.

During the year ended December 31, 2007, the Company granted 7,000 shares of restricted common stock to certain of its employees. As of June 30, 2008, 5,250 of these restricted shares were unvested and subject to forfeiture.

### 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 and retain a portion of the permanent difference between book and taxable income arising from Section 162(m) of the Code pertaining to employee remuneration.

During the quarter and six months ended June 30, 2008, FIDAC recorded \$856,000 and \$1.6 million, respectively, of income tax expense for income attributable to FIDAC, its taxable REIT subsidiary, and the portion of earnings retained based on Code Section 162(m) limitations. During the quarter and six months ended June 30, 2008, Annaly recorded \$6.7 million and \$10.5 million, respectively, of income tax expense for a portion of earnings retained based on Section 162(m) limitations. The effective tax rate was 52% for the quarter ended June 30, 2008.

During the quarter and six months ended June 30, 2007, the Company recorded approximately \$497,000 and \$925,000, respectively, of income tax expense for income attributable to FIDAC, its taxable REIT subsidiary, and the portion of earnings retained based on Section 162(m) limitations. During the quarter and six months ended June 30, 2007, Annaly recorded approximately \$342,000 and \$2.5 million, respectively, of income tax expense for a portion of earnings retained based on Section 162(m) limitations.

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The statutory combined federal, state, and city corporate tax rate is 45%. This amount is applied to the amount of estimated REIT taxable income retained (if any, and only up to 10% of ordinary income as all capital gain income is distributed) and to taxable income earned at the taxable subsidiaries. Thus, as a REIT, the Company's effective tax rate is significantly less as it is allowed to deduct dividend distributions.

### 12. LEASE COMMITMENTS AND CONTINGENCIES

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The Company has a non-cancelable lease for office space, which commenced in May 2002 and expires in December 2009. The Company's aggregate future minimum lease payments are as follows:

|                                | Total per Year<br>(dollars in thousands) |     |
|--------------------------------|--|-----|
|                                | -----                                    |     |
| 2008 (remainder)               | \$                                       | 266 |
| 2009                           |  | 532 |
|                                | -----                                    |     |
| Total remaining lease payments | \$                                       | 798 |
|                                | =====                                    |     |

From time to time, the Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Company's consolidated financial statements.

### 13. INTEREST RATE RISK

The primary market risk to the Company is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond the Company's control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with the interest-bearing liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of the Investment Securities and the Company's ability to realize gains from the sale of these assets. A decline in the value of the Investment Securities pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels. Liquidation of collateral at losses could have an adverse accounting impact, as discussed in Note 1.

The Company seeks to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. The Company may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in the portfolio of Investment Securities by entering into interest rate agreements such as interest rate caps and interest rate swaps. As of June 30, 2008, the Company entered into interest rate swaps to pay a fixed rate and receive a floating rate of interest, with a total notional amount of \$17.7 billion.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Mortgage-Backed Securities. The Company will seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets purchased at a premium with assets purchased at a discount. To date, the aggregate premium exceeds the aggregate discount on the Mortgage-Backed Securities. As a result, prepayments, which result in the expensing of unamortized premium, will reduce net income compared to what net income would be absent such prepayments.

### 14. RELATED PARTY TRANSACTIONS

In March 2008, the Company entered into a repurchase agreement with Chimera. This agreement contains customary representations, warranties and covenants contained in such agreements. As of June 30, 2008, Chimera owed the Company \$50.0 million under this repurchase agreement, with a term of one day



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and an interest rate of 3.96%. The collateral is non-Agency mortgage-backed securities.

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### 15. SUBSEQUENT EVENTS

As of June 30, 2008, the Company had lent \$50.0 million to Chimera under the repurchase agreement. As of August 6, 2008, the Company had \$606.4 million outstanding under this agreement.

The Company has signed a definitive merger agreement to acquire Merganser Capital Management Limited Partnership, a Boston-based institutional fixed-income manager which, at June 30, 2008, had \$4.8 billion in assets under management. The acquisition is expected to close in the fourth quarter of 2008.

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

#### Special Note Regarding Forward-Looking Statements

Certain statements contained in this quarterly report, and certain statements contained in our future filings with the Securities and Exchange Commission (the "SEC" or the "Commission"), in our press releases or in our other public or shareholder communications may not be based on historical facts and are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements, which are based on various assumptions, (some of which are beyond our control) may be identified by reference to a future period or periods, or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue," or similar terms or variations on those terms, or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors, including, but not limited to, changes in interest rates, changes in yield curve, changes in prepayment rates, the availability of mortgage-backed securities for purchase, the availability of financing, and, if available, the terms of any financings, changes in the market value of our assets, changes in business conditions and the general economy, and risks associated with the investment advisory business of FIDAC, including the removal by FIDAC's clients of assets FIDAC manages, FIDAC's regulatory requirements, and competition in the investment advisory business, changes in governmental regulations affecting our business, and our ability to maintain our classification as a REIT for federal income tax purposes. For a discussion of the risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements, see our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q. We do not undertake and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

Overview

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We are a REIT that owns and manages a portfolio of mortgage-backed securities. Our principal business objective is to generate net income for distribution to our stockholders from the spread between the interest income on our investment securities and the costs of borrowing to finance our acquisition of investment securities and from dividends we receive from FIDAC. FIDAC is our wholly-owned taxable REIT subsidiary, and is a registered investment advisor that generates advisory and service fee income. We acquired approximately 3.6 million shares of common stock of Chimera Investment Corporation, or Chimera, for approximately \$54.3 million in connection with Chimera's initial public offering on November 21, 2007. In addition to our investment, Chimera raised net proceeds of approximately \$479.3 million in its initial public offering. Chimera is a newly-formed, publicly traded, specialty finance company that invests in residential mortgage loans, residential mortgage-backed securities, real estate related securities and various other asset classes. Chimera is externally managed by FIDAC and intends to elect and qualify to be taxed as a REIT for federal income tax purposes. We also own 100% of an investment fund.

We are primarily engaged in the business of investing, on a leveraged basis, in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans (collectively, "Mortgage-Backed Securities"). We also invest in Federal Home Loan Bank ("FHLB"), Federal Home Loan Mortgage Corporation ("FHLMC"), and Federal National Mortgage Association ("FNMA") debentures. The Mortgage-Backed Securities and agency debentures are collectively referred to herein as "Investment Securities."

Under our capital investment policy, at least 75% of our total assets must be comprised of high-quality mortgage-backed securities and short-term investments. High quality securities means securities that (1) are rated within one of the two highest rating categories by at least one of the nationally recognized rating agencies, (2) are unrated but are guaranteed by the United States government or an agency of the United States government, or (3) are unrated but we determine them to be of comparable quality to rated high-quality mortgage-backed securities.

The remainder of our assets, comprising not more than 25% of our total assets, may consist of other qualified REIT real estate assets which are unrated or rated less than high quality, but which are at least "investment grade" (rated "BBB" or better by Standard & Poor's Corporation ("S&P") or the equivalent by another nationally recognized rating agency) or, if not rated, we determine them to be of comparable credit quality to an investment which is rated "BBB" or better. In addition, we may directly or indirectly invest part of this remaining 25% of our assets in other types of securities, including without limitation, unrated debt, equity or derivative securities, to the extent consistent with our REIT qualification requirements. The derivative securities in which we invest may include securities representing the right to receive interest only or a disproportionately large amount of interest, as well as inverse floaters, which may have imbedded leverage as part of their structural characteristics.

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We may acquire Mortgage-Backed Securities backed by single-family residential mortgage loans as well as securities backed by loans on multi-family, commercial or other real estate related properties. To date, all of the Mortgage-Backed Securities that we have acquired have been backed by single-family residential mortgage loans.

We have elected to be taxed as a REIT for federal income tax purposes. Pursuant to the current federal tax regulations, one of the requirements of

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maintaining our status as a REIT is that we must distribute at least 90% of our REIT taxable income (determined without regard to the deduction for dividends paid and by excluding any net capital gain) to our stockholders, subject to certain adjustments.

The results of our operations are affected by various factors, many of which are beyond our control. Our results of operations primarily depend on, among other things, 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, all of which involve various risks and uncertainties. Prepayment speeds, as reflected by the Constant Prepayment Rate, or CPR, and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds on our Mortgage-Backed Securities portfolio increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. The CPR on our Mortgage-Backed Securities portfolio averaged 16% and 15% for the quarters ended June 30, 2008 and 2007, respectively. Since changes in interest rates may significantly affect our 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.

The current situation in the sub-prime mortgage sector, and the current weakness in the broader mortgage market, could adversely affect one or more of our lenders and could cause one or more of our lenders to be unwilling or unable to provide us with additional financing. This could potentially increase our 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, and this could negatively impact the value of the securities in our portfolio, thus reducing its net book value. Furthermore, if many of our lenders are unwilling or unable to provide us with additional financing, we could be forced to sell our Investment Securities at an inopportune time when prices are depressed. Even with the current situation in the sub-prime mortgage sector we do not anticipate having difficulty converting our assets to cash or extending financing term, due to the fact that our investment securities have an actual or implied "AAA" rating and principal payment is guaranteed FHLMC, FNMA, or GNMA.

The table below provides quarterly information regarding our average balances, interest income, yield on assets, average repurchase agreement balances, interest expense, cost of funds, net interest income and net interest rate spreads for the quarterly periods presented.

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| Average<br>Interest<br>Earning Assets<br>Held (1) | Total<br>Interest<br>Income | Yield on<br>Average<br>Interest<br>Earning<br>Assets | Average<br>Balance of<br>Repurchase<br>Agreements | Interest<br>Expense | Average<br>Cost of<br>Funds |
|---|-----------------------------|--|---|---------------------|-----------------------------|
|---|-----------------------------|--|---|---------------------|-----------------------------|

-----  
(ratios for the quarters have been annualized, dollars in thousands)

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|  |              |           |       |              |           |       |
|--|--------------|-----------|-------|--------------|-----------|-------|
| Quarter Ended<br>June 30, 2008         | \$56,197,550 | \$773,359 | 5.50% | \$50,359,825 | \$442,251 | 3.51% |
| Quarter Ended<br>March 31, 2008        | \$56,119,584 | \$791,128 | 5.64% | \$51,399,101 | \$537,606 | 4.18% |
| Quarter Ended<br>December 31, 2007     | \$49,619,857 | \$720,925 | 5.81% | \$45,272,782 | \$558,435 | 4.93% |
| Quarter Ended<br>September 30,<br>2007 | \$43,075,489 | \$628,696 | 5.84% | \$40,201,513 | \$519,118 | 5.17% |
| Quarter Ended<br>June 30, 2007         | \$38,822,274 | \$556,262 | 5.73% | \$36,560,359 | \$468,748 | 5.13% |
| Quarter Ended<br>March 31, 2007        | \$31,682,974 | \$449,564 | 5.68% | \$29,834,208 | \$380,164 | 5.10% |

(1) Does not reflect unrealized gains/(losses).

The following table presents the CPR experienced on our Mortgage-Backed Securities portfolio, on an annualized basis, for the quarterly periods presented.

| Quarter Ended      | CPR |
|--------------------|-----|
| -----              | --- |
| June 30, 2008      | 16% |
| March 31, 2008     | 15% |
| December 31, 2007  | 12% |
| September 30, 2007 | 14% |
| June 30, 2007      | 15% |
| March 31, 2007     | 17% |

We believe that the CPR in future periods will depend, in part, on changes in and the level of market interest rates across the yield curve, with higher CPRs expected during periods of declining interest rates and lower CPRs expected during periods of rising interest rates.

We continue to explore alternative business strategies, alternative investments and other strategic initiatives to complement our core business strategy of investing, on a leveraged basis, in high quality Investment Securities. No assurance, however, can be provided that any such strategic initiative will or will not be implemented in the future.

For the purposes of computing ratios relating to equity measures, throughout this report, equity includes Series B preferred stock, which has been treated under GAAP as temporary equity. Even though it is treated as temporary equity for GAAP purposes, we believe that for financial performance measures it should be considered equity to provide a more realistic measure of our performance.

### Critical Accounting Policies

Management's discussion and analysis of financial condition and results of operations is based on the amounts reported in our financial statements. These financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the financial statements, management is required to make various judgments, estimates and assumptions that affect the reported amounts. Changes in these estimates and assumptions could have a material effect on our financial statements. The following is a summary of our policies most affected by management's judgments, estimates and assumptions.

**Valuation of Investment Securities:** All assets classified as available-for-sale are reported at fair value, based on market prices. Although

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we generally intend to hold most of our Investment Securities until maturity, we may, from time to time, sell any of our Investment Securities as part our overall management of our portfolio. Accordingly, we are required to classify all of our Investment Securities as available-for-sale. Our policy is to obtain market values from independent sources. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Investments with unrealized losses are not considered other-than-temporarily impaired if the Company has the ability and intent to hold the investments for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Unrealized losses on Investment Securities that are considered other than temporary, as measured by the amount of decline in fair value attributable to factors other than temporary, are recognized in income and the cost basis of the Investment Securities is adjusted.

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**Interest income:** Interest income is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized or accreted into interest income over the projected lives of the securities using the interest method. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, Wall Street consensus prepayment speeds, and current market conditions. If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

**Income Taxes:** We have elected to be taxed as a REIT and intend to comply with the provisions of the Internal Revenue Code of 1986, as amended (or the Code), with respect thereto. Accordingly, we will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. We and FIDAC have made a joint election to treat FIDAC as a taxable REIT subsidiary. As such, FIDAC is taxable as a domestic C corporation and subject to federal and state and local income taxes based upon its taxable income.

**Impairment of Goodwill and Intangibles:** Our acquisition of FIDAC was accounted for using the purchase method. The cost of FIDAC was allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of cost over the fair value of the net assets acquired was recognized as goodwill. Goodwill and finite-lived intangible assets are periodically reviewed for potential impairment. This evaluation requires significant judgment.

**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 their financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined). Additionally, companies are required to provide enhanced disclosure regarding instruments in the level 3

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category (the valuation of which require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. SFAS 157 was adopted by us on January 1, 2008. SFAS 157 did not have an impact on the manner in which we estimate fair value, but it requires additional disclosures.

In February 2007, the FASB issued SFAS No 159, The Fair Value Option for Financial Assets and Financial Liabilities - including an amendment of FASB Statement No. 115 ("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 was effective for us commencing January 1, 2008. We are not expecting SFAS 159 to have an effect on the consolidated financial statements. We did not elect the fair value option for any existing eligible financial instruments.

In April 2007, the FASB issued a FASB Staff Position FIN 39-1 ("FSP FIN 39-1") which modifies FASB Interpretation No. 39, Offsetting of Amounts relating to Certain Contracts ("FIN 39"). FSP FIN 39-1 addresses whether a reporting entity that is party to a master netting arrangement can offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with FIN 39. Upon adoption of this guidance, a reporting entity is permitted to change its accounting policy to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements. This guidance was effective for the Company on January 1, 2008. The implementation did not have an effect on our financial statements.

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In February 2008, the FASB issued FASB Staff Position No. FAS 140-3 Accounting for Transfers of Financial Assets and Repurchase Financing Transactions, ("SFAS FAS 140-3"). SFAS FAS 140-3 addresses whether transactions where assets purchased from a particular counterparty and financed through a repurchase agreement with the same counterparty can be considered and accounted for as separate transactions, or are required to be considered "linked" transactions and may be considered derivatives under SFAS No. 133. SFAS FAS 140-3 requires purchases and subsequent financing through repurchase agreements be considered linked transactions unless all of the following conditions apply: (1) the initial purchase and the use of repurchase agreements to finance the purchase are not contractually contingent upon each other; (2) the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed; (3) the financial assets are readily obtainable in the market; and (4) the financial instrument and the repurchase agreement are not coterminous. This SFAS is effective for the Company on January 1, 2009. We are currently evaluating SFAS FAS 140-3 but do not expect its application to have a significant impact on our financial reporting.

In March 2008, the FASB issued SFAS No. 161 ("SFAS 161"), Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement 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 (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged

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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 us January 1, 2009. We utilize interest rate swaps which are designated as cash flow hedges under SFAS 133 and therefore expect that adoption of SFAS 161 will increase footnote disclosure to comply with the disclosure requirements for financial statements issued after January 1, 2009.

Results of Operations: For the Quarters and Six Months Ended June 30, 2008 and 2007

### Net Income Summary

For the quarter ended June 30, 2008, our net income was \$308.0 million or \$0.60 basic income per average share related to common shareholders, as compared to \$85.7 million or \$0.30 basic net income per average share for the quarter ended June 30, 2007. Net income per average share increased by \$0.30 per average share available to common shareholders and total net income increased \$222.3 million for the quarter ended June 30, 2008, when compared to the quarter ended June 30, 2007. We attribute the increase in total net income for the quarter ended June 30, 2008 from the quarter ended June 30, 2007 to an increase in net interest income, resulting from the increased asset base, and the increase in interest rate spread. Net interest income increased by \$243.6 million for the quarter ended June 30, 2008, as compared to the quarter ended June 30, 2007.

For the six months ended June 30, 2008, our net income was \$551.0 million, or \$1.14 net income per average share related to common shareholders, as compared to net income of \$153.2 million, or \$0.59 net income per average share available to common shareholders, for the six months ended June 30, 2007. We attribute the majority of the increase in net income for the six months ended June 30, 2008 from the six months ended June 30, 2007 to the increase in our asset base and the increase in net interest spread. For the six months ended June 30, 2008, net interest income was \$584.6 million, as compared to \$156.9 million for the six months ended June 30, 2007.

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### Net Income Summary (dollars in thousands, except for per share data)

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(ratios for the quarters have been annualized)  
-----

|                  | Quarter<br>Ended<br>June 30, 2008 | Quarter<br>Ended<br>June 30, 2007 | Six Months<br>Ended<br>June 30, 2008 |
|------------------|-----------------------------------|-----------------------------------|--------------------------------------|
|                  | -----                             | -----                             | -----                                |
| Interest income  | \$ 773,359                        | \$ 556,262                        | \$ 1,564,979                         |
| Interest expense | 442,251                           | 468,748                           | 979,979                              |

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|  |               |               |            |
|--|---------------|---------------|------------|
| Net interest income  | 331,108       | 87,514        | 584,       |
| Other income:  |               |               |            |
| Investment advisory and service fees                         | 6,406         | 5,366         | 13,        |
| Gain on sale of investment securities                        | 2,830         | 7,293         | 12,        |
| Gain on termination of interest rate swaps                   | --            | --            |            |
| Income from trading securities                               | 2,180         | 243           | 4,         |
| Dividend income from available-for-sale equity securities    | 580           | --            | 1,         |
| Loss on other-than-temporarily impaired securities           | --            | (698)         |            |
| Total other income   | 11,996        | 12,204        | 30,        |
| Expenses:  |               |               |            |
| Distribution fees  | 370           | 861           | 1,         |
| General and administrative expenses                          | 27,215        | 12,272        | 51,        |
| Total expenses   | 27,585        | 13,133        | 52,        |
| Income before income taxes and minority interest             | 315,519       | 86,585        | 563,       |
| Income taxes   | 7,527         | 839           | 12,        |
| Income before minority interest                              | 307,992       | 85,746        | 551,       |
| Minority interest  | --            | 13            |            |
| Net Income   | 307,992       | 85,733        | 551,       |
| Dividends on preferred stock                                 | 5,334         | 5,373         | 10,        |
| Net income available to common shareholders                  | \$ 302,658    | \$ 80,360     | \$ 540,    |
| Weighted average number of basic common shares outstanding   | 503,758,079   | 264,990,422   | 473,785,   |
| Weighted average number of diluted common shares outstanding | 512,678,975   | 273,578,836   | 482,813,   |
| Basic net income per average common share                    | \$ 0.60       | \$ 0.30       | \$ 1       |
| Diluted net income per average common share                  | \$ 0.59       | \$ 0.30       | \$ 1       |
| Average total assets   | \$ 60,617,914 | \$ 39,385,992 | \$ 58,379, |
| Average equity   | \$ 6,828,505  | \$ 3,269,898  | \$ 6,324,  |
| Return on average total assets                               | 2.03%         | 0.87%         | 1          |
| Return on average equity                                     | 18.04%        | 10.49%        | 17         |

Interest Income and Average Earning Asset Yield

We had average earning assets of \$56.2 billion for the quarter ended June 30, 2008 and \$38.8 billion for the quarter ended June 30, 2007. Our interest income was \$773.4 million for the quarter ended June 30, 2008, and



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\$556.3 million for the quarter ended June 30, 2007. The yield on average Investment Securities was 5.50% and 5.73% for the quarters ended June 30, 2008 and 2007, respectively. The prepayment speeds increased to an average of 16% CPR for the quarter ended June 30, 2008 from an average of 15% CPR for the quarter ended June 30, 2007. Even though the yield on assets declined by 0.23%, the total interest income increased by \$217.1 million, primarily due to the increase in average earning assets.

We had average earning assets of \$56.2 billion and \$35.3 billion for the six months ended June 30, 2008 and 2007, respectively. Our interest income was \$1.6 billion for the six months ended June 30, 2008 and \$1.0 billion for the six months ended June 30, 2007. The yield on average Investment Securities decreased from 5.71% for the six months ended June 30, 2007 to 5.57% for the six months ended June 30, 2008. Our average earning asset balance increased by \$20.9 billion and interest income increased by \$558.7 million for the six months ended June 30, 2008 as compared to the six months ended June 30, 2007. Even though yield on assets declined by 0.14%, the increase in interest income for the six months ended June 30, 2008, when compared to the six months ended June 30, 2007, resulted from the increased asset base.

### Interest Expense and the Cost of Funds

Our largest expense is the cost of borrowed funds. We had average borrowed funds of \$50.4 billion and total interest expense of \$442.3 million for the quarter ended June 30, 2008. We had average borrowed funds of \$36.6 billion and total interest expense of \$468.7 million for the quarter ended June 30, 2007. Our average cost of funds was 3.51% for the quarter ended June 30, 2008 and 5.13% for the quarter ended June 30, 2007. The cost of funds rate decreased by 162 basis points and the average borrowed funds increased by \$13.8 billion for the quarter ended June 30, 2008 when compared to the quarter ended June 30, 2007. Interest expense for the quarter ended June 30, 2008 decreased by \$26.5 million due to the decline in the cost of funding. We had average borrowed funds of \$50.9 billion and interest expense of \$979.9 million for the six months ended June 30, 2008. We had average borrowed funds of \$33.2 billion and interest expense of \$848.9 million for the six months ended June 30, 2007. Our average cost of funds was 3.85% for the six months ended June 30, 2008 and 5.11% for the six months ended June 30, 2007. Interest expense increased by \$131.0 million because the average borrowed funds increased by \$17.7 billion, even though the average cost of funds decreased by 1.26%.

Since a portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. In addition to short term financing, we have entered into longer term repurchase agreements which provide the counterparty with the right to call the balance prior to maturity date. Our average cost of funds was 0.92% above average one-month LIBOR and 0.58% above average six-month LIBOR for the quarter ended June 30, 2008. Our average cost of funds was 0.19% below average one-month LIBOR and 0.24% below average six-month LIBOR for the quarter ended June 30, 2007. Our cost of funds, when compared to six-month LIBOR and one-month LIBOR, increased in the second quarter of 2008 because, in addition to short term financing, we have entered into longer term repurchase agreements which typically have a higher cost of funds.

The table below shows our average borrowed funds, interest expense and average cost of funds as compared to average one-month and average six-month LIBOR for the quarter ended June 30, 2008, March 31, 2008, the year ended December 31, 2007 and four quarters in 2007.

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### Average Cost of Funds

(Ratios for the quarters have been annualized, dollars in thousands)

|   | Average<br>Borrowed<br>Funds | Interest<br>Expense | Average<br>Cost<br>of<br>Funds | Average<br>One-<br>Month<br>LIBOR | Average<br>Six-<br>Month<br>LIBOR | Average<br>One-Mo<br>LIBO<br>Relat<br>to<br>Avera<br>Six<br>Mont<br>LIBO |
|---|------------------------------|---------------------|--------------------------------|-----------------------------------|-----------------------------------|--|
| For the Quarter Ended<br>June 30, 2008      | \$50,359,825                 | \$ 442,251          | 3.51%                          | 2.59%                             | 2.93%                             | (0.3   |
| For the Quarter Ended March 31, 2008        | \$51,399,101                 | \$ 537,606          | 4.18%                          | 3.31%                             | 3.18%                             | 0.1  |
| For the Year Ended<br>December 31, 2007     | \$37,967,215                 | \$1,926,465         | 5.07%                          | 5.19%                             | 5.19%                             | (0.0   |
| For the Quarter Ended<br>December 31, 2007  | \$45,272,782                 | \$ 558,435          | 4.93%                          | 4.86%                             | 4.85%                             | 0.0  |
| For the Quarter Ended<br>September 30, 2007 | \$40,201,513                 | \$ 519,118          | 5.17%                          | 5.37%                             | 5.31%                             | 0.0  |
| For the Quarter Ended<br>June 30, 2007      | \$36,560,359                 | \$ 468,748          | 5.13%                          | 5.32%                             | 5.37%                             | (0.0   |
| For the Quarter Ended<br>March 31, 2007     | \$29,834,208                 | \$ 380,164          | 5.10%                          | 5.26%                             | 5.30%                             | (0.0   |

#### Net Interest Income

Our net interest income, which equals interest income less interest expense, totaled \$331.1 million for the quarter ended June 30, 2008, and \$87.5 million for the quarter ended June 30, 2007. Our net interest income increased for the quarter ended June 30, 2008, as compared to the quarter ended June 30, 2007, because of the increased average earning assets and the increased interest rate spread. Our net interest rate spread, which equals the average yield for the period less the average cost of funds for the period, was 1.99% for the quarter ended June 30, 2008 as compared to 0.60% for the quarter ended June 30, 2007. This 139 basis point increase in interest rate spread was the result in the decrease cost of funds of 162 basis points, partially offset by a decrease in the average yield of 23 basis points.

Our net interest income totaled \$584.6 million for the six months ended June 30, 2008 and \$156.9 million for the six months ended June 30, 2007. Our net interest income increased because of the increase in interest rate spread. Our net interest rate spread, which equals the average for the period less the average cost of funds for the period, was 1.72% for the six months ended June 30, 2008 as compared to 0.60% for the six months ended June 30, 2007.

The table below shows our interest income by average Investment Securities held, total interest income, yield on average interest earning assets, average balance of repurchase agreements, interest expense, average cost of funds, net interest income, and net interest rate spread for the quarters ended June 30, 2008, March 31, 2008, the year ended December 31, 2007 and the four quarters in 2007.

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Net Interest Income  
(Ratios for the quarters have been annualized, dollars in thousands)

|   | Average<br>Interest<br>Earning<br>Assets | Total<br>Interest<br>Income | Yield on<br>Average<br>Interest<br>Earning<br>Assets | Average<br>Balance of<br>Repurchase<br>Agreements | Interest<br>Expense | Average<br>Cost<br>of<br>Funds |
|---|--|-----------------------------|--|---|---------------------|--------------------------------|
| For the Quarter Ended<br>June 30, 2008      | \$56,197,550                             | \$ 773,359                  | 5.50%  | \$50,359,825                                      | \$ 442,251          | 3.51%                          |
| For the Quarter Ended<br>March 31, 2008     | \$56,119,584                             | \$ 791,128                  | 5.64%  | \$51,399,101                                      | \$ 537,606          | 4.18%                          |
| For the Year Ended<br>December 31, 2007     | \$40,800,148                             | \$2,355,447                 | 5.77%  | \$37,967,215                                      | \$1,926,465         | 5.07%                          |
| For the Quarter Ended<br>December 31, 2007  | \$49,619,857                             | \$ 720,925                  | 5.81%  | \$45,272,782                                      | \$ 558,435          | 4.93%                          |
| For the Quarter Ended<br>September 30, 2007 | \$43,075,489                             | \$ 628,696                  | 5.84%  | \$40,201,513                                      | \$ 519,118          | 5.17%                          |
| For the Quarter Ended<br>June 30, 2007      | \$38,822,274                             | \$ 556,262                  | 5.73%  | \$36,560,359                                      | \$ 468,748          | 5.13%                          |
| For the Quarter Ended<br>March 31, 2007     | \$31,682,974                             | \$ 449,564                  | 5.68%  | \$29,834,208                                      | \$ 380,164          | 5.10%                          |

### Investment Advisory and Service Fees

FIDAC is a registered investment advisor which specializes in managing fixed income securities. FIDAC generally receives annual net investment advisory fees on the gross assets it manages, assists in managing or supervises. FIDAC expanded its line of business in 2007 to manage Chimera Investment Corporation, a newly-formed specialty finance company that invests in residential mortgage loans, residential mortgage-backed securities, real estate related securities and various other asset classes. At June 30, 2008, FIDAC had under management approximately \$2.7 billion in net assets and \$11.8 billion in gross assets, compared to \$2.6 billion in net assets and \$15.7 billion in gross assets at June 30, 2007. Net investment advisory and service fees for the quarters ended June 30, 2008 and 2007 totaled \$6.0 million and \$4.5 million, respectively, net of fees paid to third parties pursuant to distribution service agreements for facilitating and promoting distribution of shares or units to FIDAC's clients. Gross assets under management will vary from time to time because of changes in the amount of net assets FIDAC manages as well as changes in the amount of leverage used by the various funds and accounts FIDAC manages.

### Gains and Losses on Sales of Investment Securities and Interest Rate Swaps

For the quarter ended June 30, 2008, we sold Investment Securities with a carrying value of \$2.1 billion for an aggregate gain of \$2.8 million. For the quarter ended June 30, 2007, we sold Investment Securities with a carrying value of \$1.4 billion for an aggregate gain of \$7.3 million. We do not expect to sell assets on a frequent basis, but may from time to time sell existing assets to move into new assets, which our management believes might have higher risk-adjusted returns, or to manage our balance sheet as part of our asset/liability management strategy.

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For the six months ended June 30, 2008, we sold Investment Securities with a carrying value of \$6.2 billion for an aggregate gain of \$12.2 million. For the six months ended June 30, 2007, we sold Investment Securities with an aggregate historical amortized cost of \$2.8 billion for an aggregate gain of \$13.4 million. The difference between the sale price and the carrying value of our Mortgage-Backed Securities will be a realized gain or a realized loss, and will increase or decrease income accordingly.

### Income from Trading Securities

Gross income from trading securities held by our investment fund, which is a combination of interest, dividends, and realized and unrealized gains and losses, totaled \$2.2 million for the quarter ended June 30, 2008 and \$4.0 million for the six months ended June 30, 2008. Gross income from trading securities totaled \$243,000 for the quarter ended June 30, 2007 and \$3.7 million for the six months ended June 30, 2007.

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### Dividend Income from Available-For-Sale Equity Securities

We acquired approximately 3.6 million shares of common stock of Chimera. The investment in Chimera is accounted for as available-for-sale equity securities.

Dividend income from available-for-sale equity securities totaled \$580,000 for the quarter ended June 30, 2008, and \$1.5 million for the six months ended June 30, 2008. For the quarter ended June 30, 2007 we did not have an investment in available-for-sale equity securities.

### Loss on Other-Than-Temporarily Impaired Securities

At each quarter end, we review each of our securities to determine if an other-than-temporary impairment charge would be necessary. We will take these charges if we determine that we do not intend to hold securities that were in an unrealized loss position for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. For the quarter and six months ended June 30, 2008 there were no losses on other-than-temporarily impaired securities. For the quarter and six months ended June 30, 2007 the loss on other-than temporarily impaired securities totaled \$698,000 and \$1.2 million, respectively.

### General and Administrative Expenses

General and administrative (or G&A) expenses were \$27.2 million for the quarter ended June 30, 2008, and \$12.3 million for the quarter ended June 30, 2007. G&A expenses as a percentage of average total assets was 0.18% and 0.12% for the quarters ended June 30, 2008 and 2007, respectively. G&A expenses were \$51.2 million for the six months ended June 30, 2008, and \$25.2 million for the six months ended June 30, 2007. The increase in G&A expenses of \$14.9 million and \$26.1 million for the quarter and six months ended June 30, 2008 was primarily the result of increased salaries.

The table below shows our total G&A expenses as compared to average total assets and average equity for the quarters ended June 30, 2008, March 31, 2008, the year ended December 31, 2007 and the four quarters in 2007.

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### G&A Expenses and Operating Expense Ratios

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(ratios for the quarters have been annualized, dollars in thousands)

|  | Total G&A<br>Expenses | Total G&A<br>Expenses/Average<br>Assets |  | Total G&A<br>Expenses/Average<br>Equity |
|--|-----------------------|---|--|---|
| For the Quarter Ended June 30, 2008      | \$ 27,215             | 0.18%                                   |  | 1.5                                     |
| For the Quarter Ended March 31, 2008     | \$ 23,995             | 0.17%                                   |  | 1.6                                     |
| -----                                    |                       |   |  |   |
| For the Year Ended December 31, 2007     | \$ 62,666             | 0.15%                                   |  | 1.6                                     |
| For the Quarter Ended December 31, 2007  | \$ 20,174             | 0.16%                                   |  | 1.7                                     |
| For the Quarter Ended September 30, 2007 | \$ 17,334             | 0.16%                                   |  | 1.9                                     |
| For the Quarter Ended June 30, 2007      | \$ 12,272             | 0.12%                                   |  | 1.5                                     |
| For the Quarter Ended March 31, 2007     | \$ 12,886             | 0.15%                                   |  | 1.7                                     |

#### Net Income and Return on Average Equity

Our net income was \$308.0 million for the quarter ended June 30, 2008, and net income was \$85.7 million for the quarter ended June 30, 2007. Our return on average equity was 18.04% for the quarter ended June 30, 2008 and 10.49% for the quarter ended June 30, 2007. Even with the increase in G&A expenses, net income for the quarter increased by \$222.3 million. We attribute the increase in total net income for the quarter ended June 30, 2008 over the quarter ended June 30, 2007 to the increase in net interest rate spread and increase in interest-earning assets.

Our net income was \$551.1 million for the six months ended June 30, 2008, and \$153.2 million for the six months ended June 30, 2007. Our return on average equity was 17.43% for the six months ended June 30, 2008 and 10.00% for the six months ended June 30, 2007. We attribute the increase in total net income for the quarter ended June 30, 2008 over the quarter ended June 30, 2007 to the increase in net interest rate spread and increase in interest-earning assets, resulting in an increase of net interest income of \$427.7 million, which was only partially offset by an increase in G&A expenses of \$26.1 million.

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The table below shows our net interest income, net investment advisory and service fees, gain (loss) on sale of Mortgage-Backed Securities and termination of interest rate swaps, loss on other-than-temporarily impaired securities, income from equity investment, G&A expenses, income taxes, minority interest, and dividend income from equity investment, each as a percentage of average equity, and the return on average equity for the quarters ended June 30, 2008, March 31, 2008, the year ended December 31, 2007, and the four quarters in 2007.

#### Components of Return on Average Equity

-----  
(Ratios for the quarters have been annualized)

|            |         |  |          |
|------------|---------|--|----------|
| Gain on    |         |  |          |
| Sale of    |         |  |          |
| Mortgage-  |         |  |          |
| Backed     |         |  |          |
| Securities | Loss on |  | Dividend |

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|  | Net Interest Income/Average Equity | Net Investment Advisory Service Fees/Average Equity | and Interest Rate Swaps/Average Equity | other-than-temporarily impaired securities/Average Equity | Income from equity investment/Average Equity | income from available-for-sale equity securities | G |
|--|------------------------------------|---|--|---|--|--|---|
| For the Quarter Ended June 30, 2008      | 19.40%                             | 0.35%   | 0.16%                                  | -   | 0.13%  | 0.03%  | ( |
| For the Quarter Ended March 31, 2008     | 17.38%                             | 0.41%   | 0.64%                                  | -   | 0.13%  | 0.06%  | ( |
| For the Year Ended December 31, 2007     | 11.56%                             | 0.50%   | 0.57%                                  | (0.03%)   | 0.52%  | 0.00%  | ( |
| For the Quarter Ended December 31, 2007  | 13.89%                             | 0.41%   | 0.16%                                  | -   | 0.61%  | 0.00%  | ( |
| For the Quarter Ended September 30, 2007 | 12.23%                             | 0.49%   | 0.65%                                  | -   | 0.93%  | -  | ( |
| For the Quarter Ended June 30, 2007      | 10.71%                             | 0.55%   | 0.89%                                  | (0.09%)   | 0.03%  | -  | ( |
| For the Quarter Ended March 31, 2007     | 9.14%                              | 0.61%   | 0.82%                                  | (0.06%)   | 0.45%  | -  | ( |

Financial Condition

Investment Securities, Available for Sale

All of our Mortgage-Backed Securities at June 30, 2008 were adjustable-rate or fixed-rate mortgage-backed securities backed by single-family mortgage loans. All of the mortgage assets underlying these mortgage-backed securities were secured with a first lien position on the underlying single-family properties. All of our mortgage-backed securities were FHLMC, FNMA or GNMA mortgage pass-through certificates or CMOs, which carry an actual or implied "AAA" rating. All of our agency debentures are callable and carry an actual "AAA" rating. We carry all of our investment assets at fair value.

We accrete discount balances as an increase in interest income over the life of Investment Securities acquired at a discount and we amortize premium balances as a decrease in interest income over the life of Investment Securities acquired at a premium. At June 30, 2008 and December 31, 2007, we had on our

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balance sheet a total of \$72.6 million and \$77.4 million, respectively, of unamortized discount (which is the difference between the remaining principal value and current historical amortized cost of our investment securities acquired at a price below principal amount) and a total of \$573.3 million and \$405.8 million, respectively, of unamortized premium (which is the difference between the remaining principal amount and the current historical amortized cost of our investment securities acquired at a price above principal amount).

We received mortgage principal repayments of \$2.8 billion for the quarter ended June 30, 2008, and \$2.0 billion for the quarter ended June 30, 2007. The average prepayment speed for the quarter ended June 30, 2008 and 2007 was 16%, and 15% respectively. Given our current portfolio composition, if mortgage principal prepayment rates were to increase over the life of our Mortgage-Backed Securities, all other factors being equal, our net interest income would decrease during the life of these Mortgage-Backed Securities as we would be required to amortize our net premium balance into income over a shorter time period. Similarly, if mortgage principal prepayment rates were to decrease over the life of our Mortgage-Backed Securities, all other factors being equal, our net interest income would increase during the life of these Mortgage-Backed Securities as we would amortize our net premium balance over a longer time period.

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The table below summarizes certain characteristics of our Investment Securities at June 30, 2008, March 31, 2008, December 31, 2007, September 30, 2007, June 30, 2007, and March 31, 2007.

| Investment Securities  |                     |                |                   |                                       |              |       |
|------------------------|---------------------|----------------|-------------------|---------------------------------------|--------------|-------|
| -----                  |                     |                |                   |                                       |              |       |
| (dollars in thousands) |                     |                |                   |                                       |              |       |
|                        | Principal<br>Amount | Net<br>Premium | Amortized<br>Cost | Amortized<br>Cost/Principal<br>Amount | Fair Value   | Valu  |
|                        | -----               | -----          | -----             | -----                                 | -----        | ----- |
| At June 30, 2008       | \$58,304,678        | \$500,721      | \$58,805,399      | 100.86%                               | \$58,749,300 |       |
| At March 31, 2008      | \$56,006,707        | \$383,334      | \$56,390,041      | 100.68%                               | \$56,853,862 |       |
| -----                  |                     |                |                   |                                       |              |       |
| At December 31, 2007   | \$52,569,598        | \$328,376      | \$52,897,974      | 100.62%                               | \$53,133,443 |       |
| At September 30, 2007  | \$44,904,820        | \$229,713      | \$45,134,533      | 100.51%                               | \$44,890,633 |       |
| At June 30, 2007       | \$39,102,277        | \$211,438      | \$39,313,715      | 100.54%                               | \$38,753,509 |       |
| At March 31, 2007      | \$39,053,196        | \$195,649      | \$39,248,845      | 100.50%                               | \$39,230,648 |       |

The table below summarizes certain characteristics of our Investment Securities at June 30, 2008, March 31, 2008, December 31, 2007, September 30, 2007, June 30, 2007, and March 31, 2007. The index level for adjustable-rate Investment Securities is the weighted average rate of the various short-term interest rate indices, which determine the coupon rate.

### Adjustable-Rate Investment Security Characteristics

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(dollars in thousands)

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|                       | Principal Amount | Weighted Average Coupon Rate | Weighted Average Term to Next Adjustment | Weighted Average Lifetime Cap | Weighted Average Asset Yield | Principal Amount at Period End as % of Total Investment Securities |
|-----------------------|------------------|------------------------------|--|-------------------------------|------------------------------|--|
| At June 30, 2008      | \$18,418,637     | 5.16%                        | 36 months                                | 9.89%                         | 4.54%                        |  |
| At March 31, 2008     | \$17,487,518     | 5.19%                        | 35 months                                | 9.73%                         | 4.40%                        |  |
| At December 31, 2007  | \$15,331,447     | 5.90%                        | 39 months                                | 9.89%                         | 5.63%                        |  |
| At September 30, 2007 | \$13,148,355     | 5.99%                        | 41 months                                | 10.02%                        | 5.68%                        |  |
| At June 30, 2007      | \$ 9,553,827     | 5.85%                        | 32 months                                | 10.11%                        | 5.77%                        |  |
| At March 31, 2007     | \$ 9,657,221     | 5.79%                        | 30 months                                | 10.05%                        | 5.66%                        |  |

Fixed-Rate Investment Security Characteristics

(dollars in thousands)

|                       | Principal Amount | Weighted Average Coupon Rate | Weighted Average Asset Yield | Principal Amount at Period End as % of Total Investment Securities |
|-----------------------|------------------|------------------------------|------------------------------|--|
| At June 30, 2008      | \$39,886,041     | 6.00%                        | 5.70%                        | 68.41%   |
| At March 31, 2008     | \$38,519,189     | 5.98%                        | 5.80%                        | 68.78%   |
| At December 31, 2007  | \$37,238,151     | 6.00%                        | 5.80%                        | 70.84%   |
| At September 30, 2007 | \$31,756,465     | 5.93%                        | 5.76%                        | 70.72%   |
| At June 30, 2007      | \$29,548,450     | 5.87%                        | 5.69%                        | 75.57%   |
| At March 31, 2007     | \$29,395,975     | 5.85%                        | 5.67%                        | 75.27%   |

At June 30, 2008 and December 31, 2007, we held Investment Securities with coupons linked to various indices. The following tables detail the portfolio characteristics by index.

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Adjustable-Rate Investment Securities by Index

June 30, 2008

| One-Month | Six-Month | Twelve-Month | 12-Month Moving | 11th District Cost of | 1-Year Treasury | Monthly Federal Cost of | Other |
|-----------|-----------|--------------|-----------------|-----------------------|-----------------|-------------------------|-------|
|-----------|-----------|--------------|-----------------|-----------------------|-----------------|-------------------------|-------|



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|  | Libor | Libor  | Libor  | Average | Funds  | Index  | Funds  | Ind |
|--|-------|--------|--------|---------|--------|--------|--------|-----|
| Weighted Average Term to Next Adjustment   | 1 mo. | 29 mo. | 58 mo. | 1 mo.   | 1 mo.  | 32 mo. | 1 mo.  |     |
| Weighted Average Annual Period Cap   | 6.27% | 2.60%  | 2.00%  | 0.01%   | 1.73%  | 1.89%  | 0.00%  |     |
| Weighted Average Lifetime Cap at June 30, 2008                                     | 6.92% | 10.71% | 10.96% | 9.18%   | 10.84% | 10.86% | 13.42% |     |
| Investment Principal Value as Percentage of Investment Securities at June 30, 2008 | 8.25% | 2.40%  | 16.38% | 0.66%   | 0.43%  | 3.29%  | 0.11%  |     |

(1) Combination of indexes that account for less than 0.05% of total investment securities.

Adjustable-Rate Investment Securities by Index

December 31, 2007

|  | One-Month Libor | Six-Month Libor | Twelve-Month Libor | 12-Month Moving Average | 11th District Cost of Funds | 1-Year Treasury Index | 3-Year Treasury Index | M |
|--|-----------------|-----------------|--------------------|-------------------------|-----------------------------|-----------------------|-----------------------|---|
| Weighted Average Term to Next Adjustment   | 1 mo.           | 38 mo.          | 72 mo.             | 1 mo.                   | 1 mo.                       | 36 mo.                | 18 mo.                |   |
| Weighted Average Annual Period Cap   | 6.48%           | 1.72%           | 2.00%              | 0.42%                   | 0.00%                       | 1.88%                 | 2.07%                 |   |
| Weighted Average Lifetime Cap at December 31, 2007                                     | 7.13%           | 11.25%          | 11.08%             | 9.15%                   | 12.08%                      | 10.73%                | 13.18%                |   |
| Investment Principal Value as Percentage of Investment Securities at December 31, 2007 | 8.24%           | 1.89%           | 7.23%              | 0.67%                   | 0.19%                       | 3.39%                 | 0.05%                 |   |

(1) Combination of indexes that account for less than 0.05% of total investment securities.

Trading Securities and Trading Securities Sold, Not Yet Purchased

Trading securities and trading securities sold, not yet purchased, are included in the balance sheet as a result of consolidating the financial statements of an affiliated investment fund. The resulting realized and unrealized gains and losses are reflected in the statements of operations. The fair value of the trading securities was \$23.5 million and the trading securities sold, not yet purchased, was \$48.8 million at June 30, 2008. The fair value of the trading securities was \$11.7 million and the trading securities sold, not yet purchased, was \$32.8 million at December 31, 2007.

Borrowings

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To date, our debt has consisted entirely of borrowings collateralized by a pledge of our Investment Securities. These borrowings appear on our statement of financial condition as repurchase agreements. At June 30, 2008, we had established uncommitted borrowing facilities in this market with 30 lenders in amounts which we believe are in excess of our needs. All of our Investment Securities are currently accepted as collateral for these borrowings. However, we limit our borrowings, and thus our potential asset growth, in order to maintain unused borrowing capacity and thus increase the liquidity and strength of our balance sheet.

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For the quarter ended June 30, 2008, the term to maturity of our borrowings ranged from one day to ten years. We have entered into structured borrowings giving the counterparty the right to call the balance prior to maturity. The weighted average original term to maturity of our borrowings was 263 days at June 30, 2008. For the quarter ended June 30, 2007, the term to maturity of our borrowings ranged from one day to three years, with a weighted average original term to maturity of 249 days at June 30, 2007.

At June 30, 2008, the weighted average cost of funds for all of our borrowings was 3.40% with the effect of the interest rate swaps, and the weighted average term to next rate adjustment was 224 days. At June 30, 2007, the weighted average cost of funds for all of our borrowings 5.10% and the weighted average term to next rate adjustment was 209 days.

### Liquidity

Liquidity, which is our ability to turn non-cash assets into cash, allows us to purchase additional investment securities and to pledge additional assets to secure existing borrowings should the value of our pledged assets decline. We may need to pledge additional assets to collateralize interest rate swaps, if the value of the swaps decline. Potential immediate sources of liquidity for us include cash balances and unused borrowing capacity. Unused borrowing capacity will vary over time as the market value of our investment securities varies. Our non-cash assets are largely actual or implied AAA assets, and accordingly, we have not had, nor do we anticipate having, difficulty in converting our assets to cash. Our balance sheet also generates liquidity on an on-going basis through mortgage principal repayments and net earnings held prior to payment as dividends. Should our needs ever exceed these on-going sources of liquidity plus the immediate sources of liquidity discussed above, we believe that in most circumstances our Investment Securities could be sold to raise cash. The maintenance of liquidity is one of the goals of our capital investment policy. Under this policy, we limit asset growth in order to preserve unused borrowing capacity for liquidity management purposes.

Borrowings under our repurchase agreements increased by \$5.8 billion to \$51.8 billion at June 30, 2008, from \$46.0 billion at December 31, 2007. The increase in borrowings was the result of our deployment of additional capital raised the first and second quarters of 2008, which permitted us to increase our borrowings.

We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will use the collateral immediately for borrowing under a new repurchase agreement. We have not at the present time entered into any commitment agreements under which the lender would be required to enter into new repurchase agreements during a specified period of time, nor do we presently plan to have liquidity facilities with commercial banks.

Under our repurchase agreements, we may be required to pledge

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additional assets to our repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a "margin call"), which may take the form of additional securities or cash. Similarly, if the estimated fair value of our Investment Securities increases due to changes in market interest rates of market factors, lenders may release collateral back to us. Specifically, margin calls result from a decline in the value of the our Mortgage-Backed Securities securing our repurchase agreements, prepayments on the mortgages securing such Mortgage-Backed Securities and to changes in the estimated fair value of such Mortgage-Backed Securities generally due to principal reduction of such Mortgage-Backed Securities from scheduled amortization and resulting from changes in market interest rates and other market factors. Through June 30, 2008, we did not have any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should prepayment speeds on the mortgages underlying our Mortgage-Backed Securities and/or market interest rates suddenly increase, margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

The following table summarizes the effect on our liquidity and cash flows from contractual obligations for repurchase agreements, interest expense on repurchase agreements, the non-cancelable office lease and employment agreements at June 30, 2008.

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|   | (dollars in thousands) |                       |                        |                            |
|---|------------------------|-----------------------|------------------------|----------------------------|
|   | Within One<br>Year     | One to Three<br>Years | Three to<br>Five Years | More than<br>Five<br>Years |
| Contractual Obligations                   |                        |                       |                        |                            |
| Repurchase agreements                     | \$ 44,189,663          | \$ 3,300,000          | \$ 2,850,000           | \$1,500,000                |
| Interest expense on repurchase agreements | 359,032                | 409,564               | 214,659                | 230,088                    |
| Long-term operating lease obligations     | 266                    | 532                   | -                      | -                          |
| Employment contracts                      | 57,638                 | -                     | -                      | -                          |
| Total                                     | \$ 44,606,599          | \$ 3,710,096          | \$ 3,064,659           | \$1,730,088                |

### Stockholders' Equity

During the quarter ended June 30, 2008, we declared dividends to common shareholders totaling \$296.2 million or \$0.55 per share, which were paid to shareholders on July 29, 2008. During the quarter ended June 30, 2008, we declared and paid dividends to Series A Preferred shareholders totaling \$3.6 million or \$0.492188 per share, and Series B Preferred shareholders totaling \$1.7 million or \$0.375 per share. During the quarter ended June 30, 2007, we declared dividends to common shareholders totaling \$64.7 million or \$0.24 per share, which were paid on July 27, 2007. During the quarter ended June 30, 2007, we declared and paid dividends to Series A Preferred shareholders totaling \$3.6 million or \$0.492188 per share, and Series B Preferred shareholders totaling \$1.7 million or \$0.375 per share.

On May 13, 2008, we entered into an underwriting agreement pursuant to which we sold 69,000,000 shares of our common stock for net proceeds following underwriting expenses of approximately \$1.1 billion. This transaction settled on

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May19, 2008.

On January 23, 2008, we entered into an underwriting agreement pursuant to which we sold 58,650,000 shares of our common stock for net proceeds following underwriting expenses of approximately \$1.1 billion. This transaction settled on January 29, 2008.

During the quarter and six months ended June 30, 2008, we raised \$16.5 million and \$71.1 million by issuing 957,091 shares and 4.3 million shares, respectively, through the Direct Purchase and Dividend Reinvestment Program.

During the quarter and six months ended June 30, 2008, 16,600 options and 187,217 options were exercised under the Long-Term Stock Incentive Plan, or Incentive Plan, for an aggregate exercise price of \$195,000 and \$1.8 million, respectively.

On August 3, 2006, the Company entered into an ATM Equity Offering(sm) Sales Agreement with Merrill Lynch & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, relating to the sale of shares of its common stock from time to time through Merrill Lynch. Sales of the shares, if any, are made by means of ordinary brokers' transaction on the New York Stock Exchange. During the six months ended June 30, 2008, 588,000 shares of the Company's common stock were issued pursuant to this program, totaling \$11.5 million in net proceeds. On August 3, 2006, the Company entered into an ATM Equity Sales Agreement with UBS Securities LLC, relating to the sale of shares of its common stock from time to time through UBS Securities. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the six months ended June 30, 2008, 3.8 million shares of the Company's common stock were issued pursuant to this program, totaling \$60.3 million in net proceeds. During the quarter ended June 30, 2008, we did not issue stock under either ATM Equity Sales programs.

### Unrealized Gains and Losses

With our "available-for-sale" accounting treatment, unrealized fluctuations in fair values of assets do not impact our GAAP or taxable income but rather are reflected on our statement of financial condition by changing the carrying value of the asset with the change included in stockholders' equity under "Accumulated Other Comprehensive Income (Loss)."

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As a result of us using fair value accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their investments may not be meaningful.

The table below shows unrealized gains and losses on the Investment Securities, available-for-sale equity securities and interest rate swaps in our portfolio.

### Unrealized Gains and Losses ----- (dollars in thousands)

| June 30,<br>2008 | March 31,<br>2008 | December 31,<br>2007 | Septe |
|------------------|-------------------|----------------------|-------|
|------------------|-------------------|----------------------|-------|

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|                     |    |             |    |             |    |             |    |
|---------------------|----|-------------|----|-------------|----|-------------|----|
| Unrealized gain     | \$ | 324,612     | \$ | 654,506     | \$ | 379,348     | \$ |
| Unrealized loss     |    | (803,403)   |    | (990,320)   |    | (531,545)   |    |
| Net Unrealized loss |    | (\$478,791) |    | (\$335,814) |    | (\$152,197) |    |

Unrealized changes in the estimated net fair value of investment securities have one direct effect on our potential earnings and dividends: positive fair value changes increase our equity base and allow us to increase our borrowing capacity while negative changes tend to limit borrowing capacity under our capital investment policy. A very large negative change in the net fair value of our investment securities might impair our liquidity position, requiring us to sell assets with the likely result of realized losses upon sale.

Leverage

Our debt-to-equity ratio at June 30, 2008 and December 31, 2007 was 7.1:1 and 8.7:1, respectively. We generally expect to maintain a ratio of debt-to-equity of between 8:1 and 12:1, although the ratio may vary from this range from time to time based upon various factors, including our management's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity and over-collateralization levels required by lenders when we pledge assets to secure borrowings.

Our target debt-to-equity ratio is determined under our capital investment policy. Should our actual debt-to-equity ratio increase above the target level due to asset acquisition or market value fluctuations in assets, we will cease to acquire new assets. Our management will, at that time, present a plan to our board of directors to bring us back to our target debt-to-equity ratio; in many circumstances, this would be accomplished over time by the monthly reduction of the balance of our Mortgage-Backed Securities through principal repayments.

Asset/Liability Management and Effect of Changes in Interest Rates

We continually review our asset/liability management strategy with respect to interest rate risk, mortgage prepayment risk, credit risk and the related issues of capital adequacy and liquidity. Our goal is to provide attractive risk-adjusted stockholder returns while maintaining what we believe is a strong balance sheet.

We seek to manage the extent to which our net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. In addition, we have attempted to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in our portfolio of investment securities by entering into interest rate swaps. At June 30, 2008, we had entered into swap agreements with a total notional amount of \$17.7 billion. We agreed to pay a weighted average pay rate of 4.78% and receive a floating rate based on one month LIBOR. At December 31, 2007, we entered into swap agreements with a total notional amount of \$16.2 billion. We agreed to pay a weighted average pay rate of 5.03% and receive a floating rate based on one month LIBOR. We may enter into similar derivative transactions in the future by entering into interest rate collars, caps or floors or purchasing interest-only securities.

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principal prepayments and, as a result, prepayments on mortgage-backed securities. We seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets we purchase at a premium with assets we purchase at a discount. To date, the aggregate premium exceeds the aggregate discount on our mortgage-backed securities. As a result, prepayments, which result in the expensing of unamortized premium, will reduce our net income compared to what net income would be absent such prepayments.

### Off-Balance Sheet Arrangements

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

### Capital Resources

At June 30, 2008, we had no material commitments for capital expenditures.

### Inflation

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our dividends are based upon our net income as calculated for tax purposes; in each case, our activities and balance sheet are measured with reference to historical cost or fair market value without considering inflation.

### Other Matters

We calculate that at least 75% of our assets were qualified REIT assets, as defined in the Code for the quarters ended June 30, 2008 and 2007. We also calculate that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the quarters ended June 30, 2008 and 2007. Consequently, we met the REIT income and asset test. We also met all REIT requirements regarding the ownership of our common stock and the distribution of our net income. Therefore, as of June 30, 2008 and December 31, 2007 we believe that we qualified as a REIT under the Code.

We at all times intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, or the Investment Company Act. If we were to become regulated as an investment company, then our use of leverage would be substantially reduced. The Investment Company Act exempts entities that are "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" (qualifying interests). Under current interpretation of the staff of the SEC, in order to qualify for this exemption, we must maintain at least 55% of our assets directly in qualifying interests and at least 80% of our assets in qualifying interests plus other real estate related assets. In addition, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the Mortgage-Backed Securities may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of June 30, 2008 and December 31, 2007, we

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were in compliance with this requirement.

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### ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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#### MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risk to which we are exposed is interest rate risk, which is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of our Mortgage-Backed Securities and our ability to realize gains from the sale of these assets. We may utilize a variety of financial instruments, including interest rate swaps, caps, floors, inverse floaters and other interest rate exchange contracts, in order to limit the effects of interest rates on our operations. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of securities and that the losses may exceed the amount we invested in the instruments.

Our profitability and the value of our portfolio (including interest rate swaps) may be adversely affected during any period as a result of changing interest rates. The following table quantifies the potential changes in net interest income, portfolio value should interest rates go up or down 25, 50, and 75 basis points, assuming the yield curves of the rate shocks will be parallel to each other and the current yield curve. All changes in income and value are measured as percentage changes from the projected net interest income and portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates at June 30, 2008 and various estimates regarding prepayment and all activities are made at each level of rate shock. Actual results could differ significantly from these estimates.

| Change in Interest Rate | Projected Percentage Change in<br>Net Interest Income | Projected Perc<br>Portfolio Valu<br>Interest |
|-------------------------|---|--|
| -75 Basis Points        | 6.67%   | 1  |
| -50 Basis Points        | 4.03%   | 1  |
| -25 Basis Points        | 1.55%   | 1  |
| Base Interest Rate      | -   |  |
| +25 Basis Points        | (2.72%)   | 0  |
| +50 Basis Points        | (5.60%)   | (0   |
| +75 Basis Points        | (8.49%)   | (0   |

#### ASSET AND LIABILITY MANAGEMENT

Asset and liability management is concerned with the timing and magnitude of the repricing of assets and liabilities. We attempt to control risks associated with interest rate movements. Methods for evaluating interest

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rate risk include an analysis of our interest rate sensitivity "gap", which is the difference between interest-earning assets and interest-bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest-rate sensitive assets exceeds the amount of interest-rate sensitive liabilities. A gap is considered negative when the amount of interest-rate sensitive liabilities exceeds interest-rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market rates or conditions, changes in interest rates may affect net interest income positively or negatively even if an institution were perfectly matched in each maturity category.

The following table sets forth the estimated maturity or repricing of our interest-earning assets and interest-bearing liabilities at June 30, 2008. The amounts of assets and liabilities shown within a particular period were determined in accordance with the contractual terms of the assets and liabilities, except adjustable-rate loans, and securities are included in the period in which their interest rates are first scheduled to adjust and not in the period in which they mature and does include the effect of the interest rate swaps. The interest rate sensitivity of our assets and liabilities in the table could vary substantially based on actual prepayment experience.

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|  | Within 3 Months | 4-12 Months<br>(dollars in thousand) |                |
|--|-----------------|--------------------------------------|----------------|
| -----  |                 |                                      |                |
| Rate Sensitive Assets:   |                 |                                      |                |
| Investment Securities (Principal)  | \$ 6,557,474    | \$1,812,219                          | \$ 8,399,008   |
| Cash Equivalents   | 1,462,737       | -                                    | -              |
| Reverse Repurchase Agreements  | 49,964          | -                                    | -              |
|  | -----           |                                      |                |
| Total Rate Sensitive Assets  | 8,070,175       | 1,812,219                            | 8,399,008      |
| Rate Sensitive Liabilities:  |                 |                                      |                |
| Repurchase Agreements,<br>with the effect of swaps   | 26,988,463      | 2,967,550                            | 13,452,300     |
|  | -----           |                                      |                |
| Interest rate sensitivity gap  | (\$18,918,288)  | (\$1,155,331)                        | (\$5,053,292)  |
|  | =====           |                                      |                |
| Cumulative rate sensitivity gap  | (\$18,918,288)  | (\$20,073,619)                       | (\$25,126,911) |
|  | =====           |                                      |                |
| Cumulative interest rate sensitivity gap as a<br>percentage of total rate-sensitive assets | (32%)           | (34%)                                | (43%)          |
|  | =====           |                                      |                |



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Our analysis of risks is based on management's experience, estimates, models and assumptions. These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by our management may produce results that differ significantly from the estimates and assumptions used in our models and the projected results shown in the above tables and in this report. These analyses contain certain forward-looking statements and are subject to the safe harbor statement set forth under the heading, "Special Note Regarding Forward-Looking Statements."

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### ITEM 4. CONTROLS AND PROCEDURES

Our management, including our Chief Executive Officer (the "CEO") and Chief Financial Officer (the "CFO"), reviewed and evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act) as of the end of the period covered by this quarterly report. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, (1) were effective in ensuring that information regarding the Company and its subsidiaries is made known to our management, including our CEO and CFO, by our employees, as appropriate to allow timely decisions regarding required disclosure and (2) were effective in providing reasonable assurance that information the Company must disclose in its periodic reports under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods prescribed by the SEC's rules and forms. There have been no changes in our internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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## PART II. OTHER INFORMATION

### Item 1. LEGAL PROCEEDINGS

From time to time, we are involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial statements.

### Item 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2007, which could materially affect our business, financial condition or future results. The materialization of any risks and uncertainties identified in our forward looking statements contained in this report together with those previously disclosed in the Form 10-K or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Special Note Regarding Forward Looking Statements" in this quarterly report on Form 10-Q. The information presented below updates and should be read in conjunction with the risk factors and information disclosed in that Form 10-K.

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AGENCY MORTGAGE-BACKED SECURITIES THAT ARE GUARANTEED BY FNMA AND FHLMC ARE SUBJECT TO THE RISK THAT THESE U.S. GOVERNMENT-SPONSORED ENTITIES MAY NOT BE ABLE TO FULLY SATISFY THEIR GUARANTEE OBLIGATIONS, WHICH MAY ADVERSELY AFFECT THE VALUE OF OUR INVESTMENT PORTFOLIO AND OUR ABILITY TO SELL OR FINANCE THESE SECURITIES.

The interest and principal payments we expect to receive on the Mortgage-Backed Securities in which we intend to invest will be guaranteed by FNMA, FHLMC, or GNMA. Unlike the GNMA certificates in which we may invest, the principal and interest on securities issued by FNMA and FHLMC are not guaranteed by the U.S. Government. All the Mortgage-Backed Securities in which we invest depend on a steady stream of payments on the mortgages underlying the securities. The recent economic challenges in the residential mortgage market have affected the financial results of FNMA and FHLMC, and may continue to do so. FNMA recently stated that it expects severe weakness in the housing market to continue in 2008. If FNMA and FHLMC continue to suffer significant losses, their ability to honor their respective Mortgage-Backed Securities guarantees may be adversely affected. Further, any actual or perceived financial challenges at either FNMA or FHLMC could cause the rating agencies to downgrade the corporate credit ratings of FNMA or FHLMC.

Any failure to honor guarantees on Mortgage-Backed Securities by FNMA or FHLMC or any downgrade of securities issued by FNMA or FHLMC by the rating agencies could cause a significant decline in the cash flow from, and the value of, any Mortgage-Backed Securities we may own and the market for these securities may be adversely affected for a significant period of time. We may be unable to sell or finance Mortgage-Backed Securities on favorable terms or at all and our financial position and results of operations could be adversely affected.

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

- (a) The annual meeting of stockholders of Annaly Capital Management, Inc. was held on May 20, 2008.
- (b) All Class III director nominees were elected.

| Director             | Votes Received | Votes Withheld |
|----------------------|----------------|----------------|
| Michael A.J. Farrell | 329,091,414    | 59,680,024     |
| Jonathan D. Green    | 333,188,356    | 55,585,082     |
| John A. Lambiase     | 324,344,675    | 64,428,763     |

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The continuing directors of the Company are Wellington J. Denahan-Norris, Donnell A. Segalas, Kevin P. Brady, E. Wayne Nordberg and Michael Haylon. Mr. Haylon was appointed to the Board of Directors on June 13, 2008.

- (c) In addition to the election of the Class III directors, the ratification of the appointment of Deloitte & Touche LLP as our independent registered public accounting firm for 2008 was approved.

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|   | Votes Cast  |           |         |
|---|-------------|-----------|---------|
|   | For         | Against   | Abstain |
| Ratification of the appointment of independent registered public accounting firm for 2008 | 383,655,691 | 4,871,137 | 246,    |

Proposals and Vote Tabulations

- (d) A special meeting of shareholders was held on April 21, 2008 to consider and vote on an amendment of our charter to increase the number of authorized shares to 1,000,000,000 shares. The proposal was approved as follows:

|   | Votes Cast  |            |         |
|---|-------------|------------|---------|
|   | For         | Against    | Abstain |
| Proposal to amend our charter to increase the number of authorized shares to 1,000,000,000 shares | 340,435,072 | 36,866,438 | 978,    |

Item 6. EXHIBITS

Exhibits:

The exhibits required by this item are set forth on the Exhibit Index attached hereto.

EXHIBIT INDEX

| Exhibit Number | Exhibit Description   |
|----------------|---|
| 3.1            | Articles of Amendment and Restatement of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on August 5, 1997). |
| 3.2            | Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-3 (Registration Statement 333-74618) filed with the Securities and Exchange Commission on June 12, 2002).             |
| 3.3            | Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant's Form 8-K (filed with the Securities and Exchange Commission on August 3, 2006).  |
| 3.4            | Articles of Amendment of the Registrant.  |
| 3.5            | Form of Articles Supplementary designating the Registrant's 7.875% Series A Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share (incorporated by reference to Exhibit 3.3 to the Registrant's 8-A filed April 1, 2004).   |

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- 3.6 Articles Supplementary of the Registrant's designating an additional 2,750,000 shares of the Company's 7.875% Series A Cumulative Redeemable Preferred Stock, as filed with the State Department of Assessments and Taxation of Maryland on October 15, 2004 (incorporated by reference to Exhibit 3.2 to the Registrant's 8-K filed October 4, 2004).
- 3.7 Articles Supplementary designating the Registrant's 6% Series B Cumulative Convertible Preferred Stock, liquidation preference \$25.00 per share (incorporated by reference to Exhibit 3.1 to the Registrant's 8-K filed April 10, 2006).
- 3.8 Bylaws of the Registrant, as amended (incorporated by reference to Exhibit 3.3 to the Registrant's Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on August 5, 1997).
- 4.1 Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the Registrant's Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on September 17, 1997).
- 4.2 Specimen Preferred Stock Certificate (incorporated by reference to Exhibit 4.2 to the Registrant's Registration Statement on Form S-3 (Registration No. 333-74618) filed with the Securities and Exchange Commission on December 5, 2001).
- 4.3 Specimen Series A Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form 8-A filed with the SEC on April 1, 2004).
- 4.4 Specimen Series B Preferred Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant's Form 8-K filed with the Securities and Exchange Commission on April 10, 2006).
- 31.1 Certification of Michael A.J. Farrell, Chairman, Chief Executive Officer, and President of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Kathryn F. Fagan, Chief Financial Officer and Treasurer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Michael A.J. Farrell, Chairman, Chief Executive Officer, and President of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Kathryn F. Fagan, Chief Financial Officer and Treasurer of the Registrant, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ANNALY CAPITAL MANAGEMENT, INC.

Dated: August 8, 2008

By: /s/ Michael A.J. Farrell

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Michael A.J. Farrell

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(Chairman of the Board, Chief Executive Officer, President and authorized officer of registrant)

Dated: August 8, 2008

By: /s/ Kathryn F. Fagan

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Kathryn F. Fagan  
(Chief Financial Officer and Treasurer and principal financial and chief accounting officer)